July 2018

Trust in water

Putting the sector in balance: position statement on PR19 business plans

Ofwat

www.ofwat.gov.uk

About this document

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.

That letter set out that we had 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 subsequently published a consultation, in April, setting out our proposals for some targeted amendments to, and clarifications of, the PR19 methodology. These proposals focussed on what more we could do to encourage companies to take the interests of customers into account when determining financial structure. We considered how we could better incentivise companies to be transparent in demonstrating that their policies on dividends and performance related executive pay take account of delivery to customers. We also set out proposals in relation to our assessment of financial resilience in business plans.

Our consultation closed in May 2018. We carefully considered all responses and we have proposed a number of refinements to the proposals. To ensure companies had adequate time to take our decisions into account for submission of their business plans by 3 September, we published, on 3 July 2018, a summary of our decisions on the consultation issues.

This document sets out our final position on the consultation, a summary of issues raised by respondents and the detailed rationale for our decisions. We also set out our assessment of the impacts.

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Foreword

Water companies deliver essential services that are vital for public health, the environment and economy and a well-functioning society. Holding a monopoly licence to provide this service is a privilege. Customers rightly expect companies to take this special responsibility seriously and to be accountable for their actions.

Ofwat regulates by seeking to align the interests of company management and investors with the interests of customers. The current price control, which sets the revenues of the water companies until 2020, made changes to seek to increase management focus on what matters for customers, putting more weight on incentives for improving efficiency and service performance and reducing the scope for financing outperformance. The next review, PR19, will take this a significant step further.

For several years now we have also been encouraging water companies to meet the highest standard of corporate governance and transparency befitting their role as providers of an essential service. In parallel, we have been providing greater scrutiny over the long term financial viability of companies to make sure they can meet the needs of future generations.

While standards are rising overall and there are examples of water companies providing great service, there continues to be widespread concern that companies do not always operate or behave in the way expected of them. Alongside high profile service failures, concerns have been raised about high dividend payments undermining the long term capacity of companies to perform; levels of executive pay being out of step with what has been delivered for customers, and complicated and potentially risky financial structures which not only call financial resilience into question but suggest that owners are more interested in financial structure than delivering a great service.

This caused us to look again at whether we were doing all that is appropriate, within our remit, to incentivise and encourage companies to deliver the best outcomes for customers.

The consultation we launched in April this year proposed some targeted changes to the PR19 methodology we will use in the upcoming price review. We proposed that highly geared companies should share financing gains with customers; that company dividend and performance related executive pay policies should show appropriate alignment between returns to owners and executives and what is delivered for

customers; and that companies should use common financial resilience scenarios when submitting their plans.

Overall, these proposals are designed to increase the incentives on owners and executive teams to improve outcomes for customers, reduce the incentive for financial engineering, increase transparency and secure financial resilience in the sector.

Ofwat sets price limits and allowed returns for water companies. We do not propose to set dividends (the proportion of returns paid to shareholders), companies' capital structure or the levels of performance related executive pay. As private companies, the boards of water companies are responsible for decisions in all of these areas within the framework of price controls, licence conditions and company law. However, as they are also regulated companies it is appropriate that Ofwat makes sure water companies exercise these judgements in a manner consistent with their responsibilities as providers of essential public services, including to current and future customers.

A number of those who responded to the consultation agreed companies can and should do more to improve transparency and corporate behaviours in these areas. Some companies are already taking some such steps. These include de-gearing, stepping up corporate governance arrangements, providing more transparency on ownership structures and removing offshore financing vehicles.

We welcome the steps these companies are taking. However, after careful consideration, our view remains that targeted amendments to the PR19 methodology are appropriate if we are to improve the legitimacy of the sector and its public standing, and ensure that the right outcomes are achieved for customers.

These decisions stem from concerns we have had for several years and where some but not sufficient progress has been made. They allow us to put in place more effective measures for the period of the next price control rather than wait until the following price review.

Rachel Fletcher

July 2018

1 Summary

On 3 July, we published a note summarising the decisions[1] we have made on some targeted amendments to our PR19 methodology. We now set out our decisions in more detail, the reasons for our decisions and the issues raised in response to our consultation[2]. Companies will need to take these decisions into account when submitting their business plans for the period 2020-25.

Concerns about trust and confidence highlight the need for companies to do more to explain how dividends and how performance related executive pay relate to outcomes for customers. Therefore our targeted amendments consider how we can encourage companies to do more to demonstrate, transparently for customers and wider stakeholders, how their dividend and performance related executive pay policies take account of delivery of their obligations to customers.

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 also clarify our expectations for each company's assessment of financial resilience in its business plan.

1.1 Dividend policy

In a sector that provides an essential service, where customers cannot choose their supplier, it is important that customers and wider stakeholders can understand how decisions companies make about dividends relate to overall performance. Our price determinations allow efficient companies to be financeable, and it is important for customers that the decisions privately owned companies make allow them to maintain financial resilience in the long term, so that companies are able to deliver on their obligations.

[1] Ofwat, 2018, Putting the sector back in balance – summary of Ofwat's decision on issues for PR19 business plans
[2] Ofwat, 2018, Putting the sector back in balance: Consultation on proposals for PR19 business plans

Our approach is to regulate prices charged to customers and to set allowed returns for investors, as part of setting price controls. We do not regulate the level of dividends. We recognise that decisions as to the declaration and payment of dividends are best determined by companies and their boards, within the wider framework of price controls, licence obligations and company law.

We do not propose to specify the terms of dividend policies in our price determinations, nor do we propose to place controls on actual dividends paid or impose caps on dividends. However we do expect companies to take such decisions having regard to all relevant factors, particularly their wider obligations and responsibilities, and to be transparent about both their dividend policies and how such judgements are made. For example, where the long term financial resilience of the company is at risk, companies may need to restrict dividends or investors to invest more equity in a company.

We consider there is more companies can and should do to explain how their dividend policies and dividends declared or paid reflect delivery for customers. We expect companies to set out clearly in their business plans details underpinning their proposed approach to dividends and factors that would influence dividends for 2020-25. This should include the dividend yield that underpins their assessment of long term financial resilience and how this relates to their proposed approach to dividends in 2020-25.

We will assess whether business plans clearly explain how decisions on dividends will be made and how they take account of delivery of companies' obligations and commitments to customers and other stakeholders. We will also look for evidence that companies are committed to publish clear statements in their Annual Performance Reports in 2020-25 so that stakeholders can easily understand how dividends declared or paid have been determined with reference to companies' dividend policies.

Our consultation proposed a 5% nominal dividend yield as a reasonable level for assessing a base dividend for water companies in 2020-25. The base dividend we state is neither a control, nor a cap on dividends. However where companies propose base dividends above the level we have stated, there is a greater need for companies to explain how this takes due account of the customer interest. We will assess this in our initial assessment of business plans.

1.2 Performance related element of executive pay

Given the public service nature of the water sector, it is important that water companies are transparent about executive pay and how it aligns to delivery of services to customers. Performance related pay can align the interests of executives with those of customers and investors. Transparency of the relationship between pay and performance can help customers see how performance related executive pay is aligned to the provision of an essential service.

Evidence from company annual reports suggests there is more companies could do so that management incentives also reflect performance obligations and commitments to customers. It is also important that stakeholders can clearly understand the criteria for awarding performance related elements of executive pay. To encourage companies to address these issues for business plans, we retain our overall consultation position that we expect companies to set out their performance related executive pay policies in business plans for assessment in our IAP. We have however revisited and refined some of the detailed proposals.

Taking account of consultation responses, we have revised our consultation position so that we expect policies for performance related executive pay to demonstrate a substantial link to stretching performance delivery for customers. Our IAP assessment will also look for evidence that policies are transparent, relevant and will be rigorously applied.

We understand that what is meant by stretching performance may be different for each company, and so we expect 'stretching' to mean stretching performance by reference to the business plan. Companies will be responsible for demonstrating how their approach reflects customer interests including, for example, the extent to which the short and long-term performance related pay policies link to ODIs, totex, or other measures of operational performance.

We recognise that companies may need to amend their approaches over time; we will look for commitment in business plans that where changes are made, the reasons for changes, including how these take account of the customer interest, will be set out in the Annual Performance Reports.

1.3 Benefit sharing

Our PR19 methodology aims to align the interests of companies and their investors, with the interests of their customers. Our regulatory incentive mechanisms incentivise companies to deliver high levels of service and efficient cost – our aim is

to ensure that shareholder returns fairly reflect the standards of service and levels of efficiency delivered for customers.

We allow companies to recover the efficient cost of capital as part of setting price determinations. Companies are responsible for their own choices around capital and financing structures, within the framework of the price review, licences and company law, and they bear the consequences of their decisions. This is because companies and their investors are best placed to determine the financial structure appropriate to their circumstances, provided they bear the associated risks and their interests are well aligned to their customers. For example, if company choice around financing structure results in them incurring a higher cost of debt than reflected in our view of the efficient cost of capital, then companies will bear this cost. However, we are concerned that companies and their investors retain all the benefits of high gearing arrangements, with little evidence of benefits to customers. This could distort their incentives when choosing financing structures to select arrangements with excessive gearing, without fully considering potential impacts on customers and wider stakeholders.

Our consultation proposed the use of a benefit sharing mechanism to better align the incentives of companies and their investors around choice of gearing levels with customer interests. Currently, any gains from choosing gearing levels well above the notional level used in setting price controls accrue only to investors. We have come to the view that this one-sided incentive is out of keeping with our overarching aims of the price control, including the need to balance the companies' freedom to choose how they operate with the interests of current and future customers.

The engagement and responses we received to our consultation revealed a mixed reaction to our proposals. Some consultation responses questioned the economic case for change, suggested our approach was detrimental to the predictability of the regulatory regime or argued that higher returns associated with higher gearing reflected an increase in risk to equity holders. Other responses expressed support for our proposals, and in some cases urged us to go further. We have carefully considered all of the responses, including our proposals on benefit sharing.

We are concerned that company decisions that increase gearing levels materially above the notional level are not appropriately aligned to the interests of customers. Where companies adopt high levels of gearing, they may increase risk to equity investors and reduce financial resilience, it also may transfer some risk to customers and or potentially taxpayers, in the event that a company fails. High gearing may also reduce the ability of companies to adapt to changes to regulatory arrangements that are required in customer interests. Equity investors benefit from higher equity returns that are associated with their increased risk, but there is no substantive benefit passed to customers. We consider it is necessary for us to take steps now,

as delaying or deciding not to act now would lead to further dis-benefits to customers over the long term.

We have concluded that companies with gearing levels materially above our notional assumption should propose sharing mechanisms in business plans. We have however amended the mechanism proposed in our consultation to trigger only for those companies that have actual gearing levels that are 10 percentage points above our notional assumption[3]. We illustrate our default mechanism for 2020-25 in section 6.3.4.

Further, companies can propose sharing mechanisms that differ from the default mechanism we set out. Taking account of consultation responses, we will accept such alternative mechanisms if they deliver equivalent benefits for customers in the round, which may include both financial and wider impacts such as risks borne by customers. Alternative outperformance mechanisms may include a transition period where there is convincing evidence that this is in the customer interest.

1.4 Cost of debt outperformance

We confirm that we retain the approach first set out in our cost of debt consultation in 2016, that where companies have a low cost of embedded debt that they should consider proposing voluntary sharing mechanisms. This will be taken into account as part of the ‘in the round’ assessment under the trust, confidence and assurance test question 3 in the IAP, but we confirm we do not intend to impose a cost of debt sharing mechanism as a part of our PR19 methodology.

1.5 Initial assessment of business plans

We will assess dividend and performance related executive pay policies and benefit sharing proposals in our IAP. Our objective is to increase transparency and to encourage companies to take greater account of the interests of their customers. We confirm in section 7 our revisions to the ‘securing trust, confidence and assurance’ IAP test question 3. We will take account of voluntary cost of debt outperformance mechanisms as part of our ‘in the round’ assessment.

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[3] The notional gearing assumption that underpinned our early view of the cost of capital for PR19 was 60%. Our policy means that benefit sharing would trigger only for those companies that report gearing of 70% or more.

1.6 Financial resilience

Our PR19 methodology highlighted the importance of resilience, so that the water sector can plan, invest and operate to meet the needs of current and future customers, in a way that offers best value for money in the long term. The PR19 methodology set out that we would assess 'resilience in the round' with particular reference to operational, financial and corporate resilience.

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.

Each company's board is responsible for ensuring the company is financially resilient and we expect each company's board to be able demonstrate how it has assured itself that this is the case when business plans are submitted, using modelling scenarios relevant to their own circumstances.

In addition, to facilitate our IAP assessment and provide greater insights across the sector, we confirm that companies should assess a common suite of scenarios in assessing their ability to cope with and recover from disruption. We have amended three of the scenarios proposed in our consultation, taking account of views expressed in consultation responses.

1.7 Application of our decisions

The decisions set out in this document are relevant to companies in England and Wales and are consistent with the strategic priorities and objectives of UK and Welsh Governments, in particular the priorities relating to resilience and a strong focus on customer protection.

We consider the regulatory burden on companies of the decisions in this document to be minimal. They are necessary to address ongoing and persistent concerns so that companies can rebuild trust and confidence in the sector. 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.

Our benefit sharing decisions apply only to highly geared companies. The impacts of our decisions are summarised in Appendix 2. The impacts could amount to a transfer of benefits of between £200 million and £230 million from shareholders to customers over the period 2020-25. For context, the expected turnover for the current (2015-20)

period for the sector is over £55 billion. We note however that actual impacts could vary depending on whether companies put forward alternative mechanisms and depending on actual gearing levels which could vary compared with our assumptions.

The rest of this document is set out as follows:

- Section 2 sets out a reminder of the overall balance of risk and return in our PR19 methodology
- Section 3 summaries the contents of our consultation, the consultation process and responds to comments we received on the consultation process.
- Section 4 sets out our conclusions, in light of the consultation, about linking dividend policy with delivery for customers.
- Section 5 sets out our conclusions, in light of the consultation, about linking performance related executive pay with delivery for customers.
- Section 6 sets out our conclusions, in light of the consultation, around the sharing of financing outperformance in 2020-25
- Section 7 sets out our amendments to the “Securing trust, confidence and assurance” IAP test area, and
- Section 8 sets out our conclusions, in light of the consultation, for companies’ statement of financial resilience in business plans and the evidence to be provided to support these statements.

2 The balance of risk and return in our PR19 methodology

Our PR19 methodology aims to align 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 PR19 methodology which allocate risk and share benefits between companies (and their investors) 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 receive outperformance adjustments if they deliver improvements for customers via the Outcome Delivery Incentives, Customer Measure of Experience and Developer Measure of Experience mechanisms.
- Financing – our PR19 methodology allocated the risk of financing out/under performance to companies with the exception of the cost of new debt, which is subject to an indexation mechanism. This means companies no longer bear the risk of market movements relative to forecast at the 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.

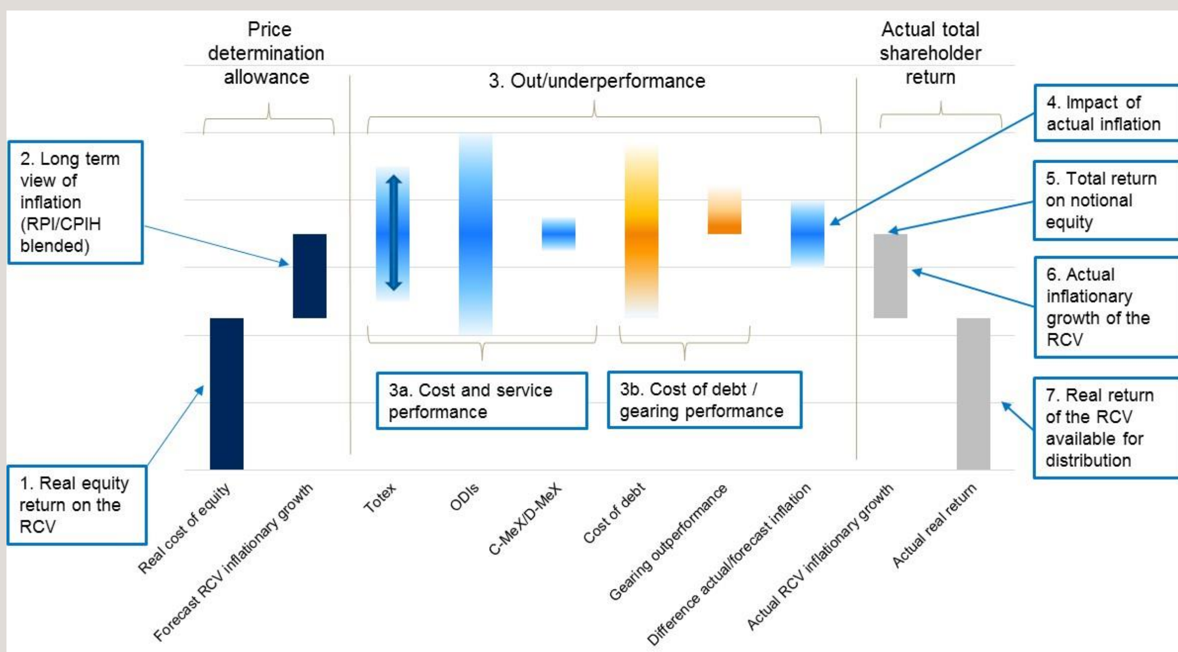
Our PR19 methodology illustrated the scope for out/underperformance of the regulatory incentive mechanisms by reference to the return on regulatory equity (RoRE). In Figure 1, we expand the analysis previously set out in our PR19 methodology to demonstrate the ways in which investors earn their returns. 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 were and were not included in the PR19 methodology for sharing outperformance with customers. The sources of investor returns in Figure 1 are not exhaustive. Investor returns can also be impacted by factors such as fines, gains or losses associated with pension deficits 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 they fall outside of the regulated activities.

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 document 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 that underpins our cost of capital 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 of 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. Reconciliation adjustments will be made in 2020-25. 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 the cost of 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[4] 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.

[4] Ofwat, 2016, Consultation on the approach to the cost of debt for PR19

3 Our consultation on proposals to put the sector in balance.

Our consultation on targeted amendments to the PR19 methodology forms part of a wider programme of work, building on the changes we made at PR14 to increase company focus on what matters for customers, putting more weight on incentives for improving efficiency and service performance and reducing the scope for financing outperformance.

It follows a number of steps we have taken that aim to put the sector in balance. This includes the work we are undertaking to update and strengthen our Board Leadership Governance and Transparency principles and to consider licence changes that are necessary to ensure the financial ring-fence remains fit for purpose, alongside our broader work on the longer term vision for, and direction of the sector.

We have carried out a wide programme of engagement on these issues, to provide clarity on the scope of our work, which includes:

- letters sent by our Chairman, Jonson Cox, to companies following his Utility Week article published in 2017.
- A letter to the Secretary of State dated 31 January 2018 which referenced our work to increase transparency of company returns.
- A subsequent letter to the Secretary of State dated 9 April 2018 which set out our proposals on benefit sharing (covering financing outperformance, executive pay, dividends and financial resilience) and our intention to consult.
- A letter to the Chief Executive Officers of the water companies dated 13 April 2018 which confirmed the programme of work we are carrying out to put the sector in balance, including a consultation on targeted amendments to our PR19 methodology.

We published our formal consultation in April 2018. The consultation included proposals for some targeted amendments and clarifications to our PR19 methodology to better align the interests of investors in water companies with the interests of 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 expectations for how our IAP assessment would take account of how those policies linked to the customer interest; and,

- proposals clarifying how we expect companies to demonstrate financial resilience in business plans.

The consultation closed in May. 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 a summary of the decisions[5] we made on 3 July.

3.1 Consultation responses

We received 32 responses to the consultation. Responses were received from:

- All of the water or water and sewerage companies subject to the PR19 price controls except Hafren Dyfrdwy Limited (previously known as Dee Valley Water).
- Eleven responses were received from investors (or groups of investors) in companies. Except for one response, these represented views from investors in companies with gearing in excess of 70% as at 31 March 2017.
- Customer interest groups, which included CC Water and the Bristol Water Challenge Panel.
- Other interested parties, which comprised the Pensions Regulator, Water Plus and the London Fire Brigade.

We list all respondents in Appendix 1 and their responses are published on our website.

We also received letters from three companies and a joint letter from two companies setting out further details in response to our consultation after the consultation closed. We have also published those responses on our website.

In some cases, responses were supported with reports. These included a report commissioned by a number of respondents from KPMG (which included a supporting note from Alan Gregory of Exeter University) and a paper commissioned by Southern Water from Oxera.

[5] Ofwat, July 2018, Putting the sector back in balance – summary of Ofwat's decision on issues for PR19 business plans.

While the consultation period was open, we engaged extensively with interested parties. We discussed our proposals in 16 meetings with investors and held two investor roundtable events. We also engaged extensively with other stakeholders with an interest in our proposals.

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

3.2 Consultation process

Several respondents commented that the three week consultation period was too short, particularly as it related to changes to the PR19 methodology. Some commented that our consultation failed to recognise the steps companies are already taking to put the sector in balance.

Some respondents commented that the PR19 methodology was subject to extensive engagement with stakeholders, and suggested that late changes to the PR19 methodology ran counter to the principle of regulatory predictability. Affinity Water's response was notable in this respect; the company commented that it did not agree that the PR19 Final Methodology should be re-opened and amended, which led it to object to all of the proposals set out in the consultation.

3.2.1 Our assessment of the issues raised in consultation responses on process

We recognise that some companies have already signalled commitments to take steps with the aim of putting the sector in balance. The steps some companies have signalled include:

- the removal of Cayman Islands subsidiaries;
- measures to increase board effectiveness, including changes to the composition of boards; and,
- reducing current and forecast dividends to lower debt and gearing.

The consultation period reflected a number of factors, including that we had already signalled the need for companies to take steps to put the sector in balance, as set out above, and discussed the issues associated with highly geared structures with companies in preceding months. It reflected that the concept of benefit sharing proposals was not new, having been discussed in our 2016 cost of debt consultation.

The consultation period was proportionate to the scale of the changes and necessary for us to have time properly to consider responses, and publish our decisions so that companies could take them into account for final preparation of their business plans by 3 September. We announced our decisions on the outcome of the consultation on 3 July 2018, to allow sufficient time for companies to take them into account in finalising their plans.

As set out above, we have engaged extensively with stakeholders through, and subsequent to, the consultation period, particularly to ensure our proposals were understood by investors with an interest in the sector.

We recognise the importance companies and their investors place on the predictability of the regulatory regime, along with other principles such as adaptability. We hoped and expected that further changes would not be needed after we published our PR19 methodology, six months ahead of the equivalent timetable for PR14. However, the need to look again to ensure we are taking appropriate steps to ensure the regulatory regime sufficiently aligns company and investor interests to the interests of current and future customers has become clearer since publication of the PR19 methodology. It has been reinforced by the failure of the sector as a whole to sufficiently recognise and respond to criticism from multiple stakeholders.

It is our responsibility to be prepared to address such issues, even when it creates some degree of additional, short term, uncertainty. We note the changes are made for the price controls to apply from April 2020 and that our decision is well in advance of the new review period and that regulatory predictability needs to be considered alongside the adaptability of the framework.

4 Linking dividend policy with delivery for customers

This section sets out our expectations regarding the disclosure of dividends in business plans for 2020-25. We summarise our consultation proposals, issues raised in response, our position taking account of the issues raised and our approach to the IAP assessment.

Linking dividend policy with delivery for customers – summary of final position

Companies should set out details underpinning their proposed approach to **dividends** and factors that would influence dividends for 2020-25 transparently in their business plans. This should include the dividend yield that underpins their assessment of long term financial resilience and how this relates to their proposed approach to dividends in 2020-25. Companies should explain how their approach will take account of delivery for customers over the period of the price control.

We will assess each company's approach within our **IAP**. We will look for evidence that companies have taken account of factors that matter to customers and their employees, including, for example, how their dividend policies take account of the delivery of obligations and commitments to customers. Factors we will assess include out/underperformance and benefit sharing, employee interests, pension obligations, actual capital structure, the need to finance future investment (RCV growth) and financial resilience.

For the purposes of the IAP assessment, we reference 5% as a reasonable nominal **base dividend yield** (based on a company's actual financial structure) for a company performing in line with the price determination. We clarify the reference to base dividend yield is neither a control, nor a cap on dividends. Dividend policy is a matter for each company and its board and base dividends can be higher or lower. What we are seeking to achieve is that company boards should take appropriate account of the interests of their customers, and wider stakeholders, when making decisions on dividends, and that they are transparent and clear in the judgements that have been made.

We will look for commitment from companies in their business plans that Annual Performance Reports in 2020-25 will transparently set out dividend policies, and how dividends declared or paid relate to that policy. Where companies make

changes to dividend policies, we expect this to be clearly signalled to stakeholders in Annual Performance Reports.

4.1 Consultation proposals - Dividends

Our consultation proposed that companies must be transparent about how their dividends relate to delivery of service to customers.

We stated “companies can improve trust and confidence if they are able to demonstrate that dividends have been paid only after they have confirmed that 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.”

Our consultation proposed companies should set out their dividend policies for 2020-25 in their business plans and explain how dividend policies would take account of delivery for customers over the period of the price control. We said we would assess these in our IAP assessment.

We set out that it is for each company to determine its own dividend policy, including the level of the base dividend. Based on evidence from the European market as a whole, we suggested a maximum nominal base dividend yield of 5% as reasonable for the purposes of our IAP assessment. We said that 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 base dividends are in customers’ interests.

Our consultation also set out our expectations for reporting of actual dividends over 2020-25. We said we expect companies to be transparent about the dividends paid and how these relate to company performance.

4.2 Consultation responses - Dividends

All respondents apart from four commented on our dividend policy proposals. Most respondents agreed with the need for transparency and the need to draw links to underlying company performance as this will enhance trust and confidence in the

sector and drive the right corporate behaviour (26 out of 32 respondents were supportive, 4 made no comment and 2 disagreed). Some were supportive of the increased focus brought about by assessing dividend policies in the IAP, others noted the principle that distributions should be reasonable and sustainable, and appreciated the need for Ofwat to address this issue.

Three respondents considered that a base dividend yield of around 5% was appropriate for investors in this sector, but most respondents were concerned our proposals were too restrictive or prescriptive. In particular some respondents read our proposals as setting a maximum dividend yield or dividend cap. But, amongst these respondents, there was still some agreement that dividends should reflect performance to customers.

Eleven respondents considered that dividend policy is solely a matter for the board, or is an essential function of boards, with one respondent stating a view that “setting a specific nominal dividend yield cap is an unnecessary interference in the integrity of boards and contrary to the concept of incentive based regulation”. A few respondents stated that dividends should not be set based on meeting pre-defined hurdles or limited to a maximum percentage yield.

Several respondents argued that companies need to retain flexibility to adapt their dividend policies. Respondents suggested there are multiple factors to consider including customer outcomes, business performance, operational and financial resilience (including employee protections) and future investment requirements. Views were expressed that there are also multiple stakeholder interests to consider. Views were also expressed that investors are key stakeholders (along with customers and employees) in the consideration of what dividend to pay, if any, since the payment of dividends is a fundamental part of attracting long-term investors with a low cost of capital into the sector.

A few respondents considered that companies cannot commit to an actual level of dividend payment in their business plans for practical and legal reasons, (citing the UK Corporate Governance Code and the Listing Rules or the Companies Act provisions).

One respondent considered that it would be wrong for Ofwat to apply its IAP assessment in a manner which effectively compels companies to adopt an approach to performance related executive pay and dividends that incorporates specific policies proposed by Ofwat.

One respondent commented that when considering the level of dividends, company boards already have a range of prescribed factors that they must consider,

referencing the 2016 UK Corporate Governance Code[6] as well as those required under the Listing Rules[7]. The respondent referenced requirements already placed on companies that going concern statements should give due consideration to matters such as business performance, prospects of the company and principal risks "including those that would threaten its business model, future performance, solvency or liquidity". As such, when declaring any dividend, company boards consider as a matter of course operational performance, affordability, prevailing risks and future prospects. Another respondent commented that "as stewards of essential services the responsibilities of boards should practically extend beyond those enshrined in UK company law in a manner that is consistent with the privilege of being responsible for delivering monopoly services".

One investor in a highly geared company advised against requiring dividends to be paid only in the event of operational outperformance or "in relation to backwards looking tests". The respondent suggested this could discourage investment in innovation and long term planning in business plans, which require significant investment but do not produce any immediate short term benefits. The respondent suggested it would prefer "tests that are agreed at each price review and unique to each company and the feedback they have received from their customers".

One company proposed that our principles on dividends should also cover a company's track record on dividend policy. The respondent expressed a view that companies that can demonstrate a strong track record should be allowed to retain a higher degree of flexibility.

A few respondents considered that we should have a wider focus than just dividend policy, we should consider companies' dividend policies in the round as part of our broader duties or that the entire corporate responsibility policy (the sustainability of an organisation over the long term, seeking to add value to an organisation's activities by ensuring they have a positive impact on society, the environment and the economy) may be a better context into which to fit the dividend question and assessment.

The Pensions Regulator strongly welcomed our proposal that IAP assessments must include employee interests and that dividend policies should take fair account of, amongst other things, pension deficits. It cited in its response an internal review

[6] The UK Corporate Governance code published by the FRC, April 2016.
[7] The Financial Conduct Authority Handbook, Listing, Prospectus and Disclosure.

which highlighted that a number of companies have agreed recovery plans that have seen an inequitable proportion of cash flows diverted to shareholders at the expense of their schemes. The regulator commented that most companies have agreed recovery plans for their schemes that are inappropriately long and argued that shorter and thus less risky recovery plans would be appropriate. The regulator highlighted a concern that companies were citing the pension deficit repair policy adopted by Ofwat since PR09 as the basis for determining the length of recovery plans, which it did not consider was the intention and sought further clarification of the purpose of our policy. Further, the Pensions Regulator noted a concern, stated in its Annual Funding Statement published in April 2018, about the growing disparity between dividend growth and stable deficit repair contributions.

CCWater made representations that Ofwat should intervene if the company;

- fails to adequately show how dividends and total shareholder returns reflect a delivery of commitments to customers and the relatively low risk water companies' face in their business plan; and
- does not provide evidence in its annual reporting that returns are in line with this commitment, and/or is not transparent to its customers in doing so.

4.3 Our assessment of the issues raised in the consultation

In a sector that provides an essential service, where customers cannot choose their supplier, it is important that customers and wider stakeholders can understand how decisions companies make about dividends relate to overall performance. Dividends are payments of returns earned by companies to their investors. As in a well-functioning market, we would expect healthy and high performing companies to be paying dividends to their shareholders. We would also expect companies that are failing to deliver to their customers and/or with weak balance sheets to reduce or suspend dividends.

The monopoly companies operating in this sector are subject to a range of obligations, both through their licences and through statute. Many of these duties have both a short and a long-term horizon and against that background, we expect companies to ensure they have the operational, corporate and financial resilience to meet their obligations. Beyond that, many companies make additional promises or commitments to their customers that in the ordinary course, we would expect to be honoured. A key factor in a company's and its board's approach to dividends should concern the company's ability to meet its obligations and honour its commitments.

We set revenue allowances in our price determinations. This includes allowed returns, but we do not set dividends. We are clear that the responsibility for

determining dividends is for companies and their boards, within the wider framework of their price controls, their licence obligations and company law. We expect companies to be accountable for their actions, and company boards to take account of wider considerations when making decisions on dividends. This is consistent with the principle of aligning the interests of company management and investors to the interests of current and future customers.

Companies should be clear about how dividends relate to the overall shareholder return, and how decisions are made about the element of that return that is retained within the business or distributed to shareholders. Transparency can help customers and wider stakeholders understand how distributions take account of factors that include delivery of obligations, and service delivery, at an efficient cost, while maintaining resilience over the long term. These or broadly similar principles are reflected and acknowledged in most responses we received.

We have seen companies and investors restrict dividends, in our view rightly, to take account of factors related to underperformance or to address resilience concerns. Conversely investors can reasonably expect to receive higher dividends where a company outperforms. As companies' existing licence obligations reflect, excessive dividends may undermine the ability of companies to perform, including meeting future obligations, by undermining financial resilience. Further, we would expect any responsible monopoly water company, that provides an essential public service, to have regard to the impacts of its decisions on customers and wider stakeholders.

The range of annual dividend payments as a percentage of equity RCV (based on notional gearing) for the water and sewerage companies in 2010-17 are presented in Figures 2 and 3. Figure 2 compares the average dividend yield for each year of the price control for the sector with the nominal outturn cost of equity calculated on a notional basis for the sector. This is calculated as the real allowed cost of equity inflated by outturn RPI.

However, actual dividend yields vary by company. This depends on a range of factors which include capital structure and actual performance delivery to customers. Figure 3 shows the average dividend yield over 2010-17 for each company based on the notional gearing.

Figure 2 – Sector average dividend yield compared with nominal outturn cost of equity (notional basis)

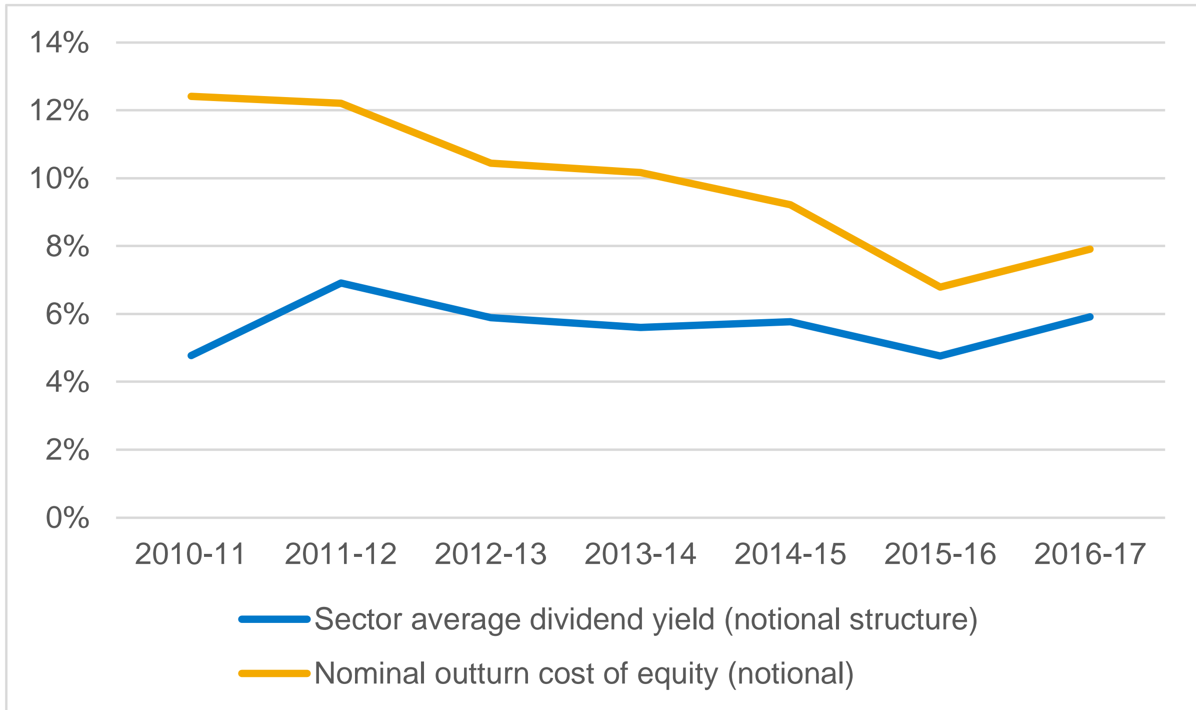
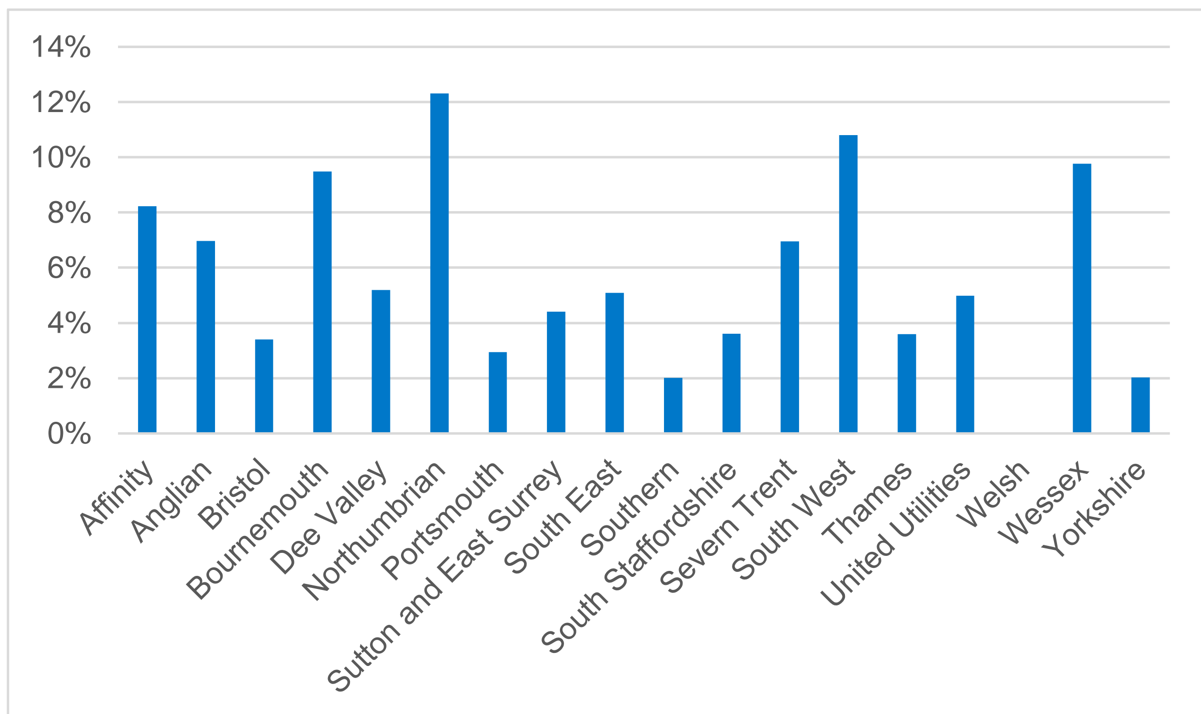


Figure 3 – Average dividend yield for 2010-17 (based on notional equity RCV)



We note the concerns raised by some companies about the practical and legal issues associated with stating a definitive dividend policy in business plans such as an explicit formula for setting dividends. However, we encourage companies to consider carefully the commitments that can be given as a necessary step to put the sector in balance. We expect companies to set out clearly in their business plans details underpinning their proposed approach to dividends and factors that will influence dividends for 2020-25. This should include the dividend yield that underpins their assessment of long term financial resilience and how this relates to their proposed approach to dividends in 2020-25.

In our initial assessment of business plans, we will assess whether companies clearly explain how decisions on dividends will be made and how they take appropriate account of delivery of companies' obligations and commitments to customers and other stakeholders.

Some respondents raised concerns about the level of the dividend yield stated in our consultation. We are clear that our proposals should not be read, and are not intended to operate, as a control on dividends or a dividend cap – our aim is to encourage companies and their boards to consider the interests of the customers they serve when making their decisions and to transparently explain how they do so.

The base dividend yield we indicated (5% in nominal terms) is in our view a reasonable reference point for a company performing in line with its price determination. It was based on the upper end of the payout ratios for the European market as a whole over 2011-17 (70%) as applied to the PR19 early view of the nominal cost of equity. We note it was supported by two company respondents and one investor respondent.

Our view remains that a 5% base dividend yield is an appropriate guide to a reasonable base dividend yield in the absence of out or underperformance in 2020-25, and we retain this for our final position. Companies may propose higher or lower base dividend yields than 5%. Where they propose a higher level of base dividends, we will expect to see a clear explanation as to how such a base dividend has been set with appropriate regard to companies' responsibilities, including to customers.

In further correspondence since the consultation closed, two companies suggested that company boards should be expected to justify the dividend in the round (i.e. from zero upwards) not simply the variance from a 5% return (or any other figure). We agree. Our proposal is that all 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. An explanation is required irrespective of the base dividend a company sets itself.

We retain the view set out in our consultation that factors companies should take into account when designing dividend policies include:

- whether companies are meeting their obligations,
- the commitments they have made to customers,
- adjustments for out/underperformance against regulatory metrics and benefit sharing,
- employee interests,
- pension obligations,
- actual capital structure, including whether, for a company with high gearing, it has considered maintaining the same dividend yield as under our notional structure,
- the need to finance future investment (RCV growth) and
- financial resilience.

We expect companies to publish detail about how dividends declared or paid have been determined and how these relate to their dividend policies in their Annual Performance Reports for 2020-25, and we expect to review this annually in 2020-25.

We agree there is a need for flexibility in the design of dividend policies; our concerns relate primarily to instances where companies do not clearly explain for customers and wider stakeholders how high dividend yields relate to service and cost delivery and/or the objective of maintaining financial resilience. Where companies need to make changes to dividend policies, we expect this to be clearly signalled to stakeholders in Annual Performance Reports.

Pension deficits

In response to the views of the Pensions Regulator, consistent with the letter sent by Cathryn Ross to all companies dated 24 February 2017, we remind companies of their obligations to funding pension deficits[8].

Our policy on pension deficit recovery was established at the 2009 price review, and reconfirmed in IN 13/17 "Treatment of companies' pension deficit repair costs at the 2014 price review" for the 2014 price review. IN 13/17 confirmed that in order to increase protection for customers over the longer term, we would time limit the future support companies receive from customers for pension deficit recovery costs. We

[8] We also set out our approach in point 3 of our letter to Rt Hon Frank Field MP, Chair of the Work and Pensions Select Committee, dated 12 April 2018.

set out for each company our assumed final payment date. The majority of these end in 2020-25.

The 24 February 2017 letter reminded companies that we continue to expect them to manage defined benefits pension scheme deficits, as some already have, and for companies and their shareholders to contribute the remaining 50% of pension deficit repair costs that we assumed would be dealt with by management action back in 2009 and any incremental repair costs arising since 2009. Nothing in our decisions in this document changes our policy on pension deficit recovery.

Companies and their shareholders are responsible for their pension deficit recovery plans. We confirm that the final payment dates that we set out in our 2009 policy were not intended to be a basis for determining the length of recovery plans. We expect companies to take account of their pension deficit and recovery plans as part of their assurance on their financial resilience.

Other issues

In response to other issues raised by respondents;

- We are not convinced by the points made that our proposal in this respect would discourage investment or innovation; companies still have obligations placed on them which require them to invest, and incentives to invest efficiently and, in doing so, to innovate. Our regulatory framework including outcome delivery incentives, totex cost sharing, wholesale markets, the regulatory asset base and focus on innovation in PR19 all provide strong incentives for efficient investment and innovation. Furthermore they can consider these issues when designing their dividend policies. Our regulatory framework recognises the importance of the sector continuing to attract investment over the long term.
- Our assessment of dividend policies in our IAP is forward looking, we do not intend to apply a retrospective assessment of dividend policies in the IAP.

Earlier this year we published guidance for the reporting of financial flows in the 2018 Annual Performance Reports. 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 confirm that we expect companies will need to report such information in a similar way in 2020-25. 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.

5 Linking performance related executive pay with delivery for customers

This section sets out our expectations regarding the disclosure of performance related executive pay policies in business plans for 2020-25. We summarise our consultation proposals, issues raised in response, our position taking account of the issues raised and our approach to the IAP assessment.

Linking performance related executive pay with delivery for customers – summary of final position

Executive pay policy is a matter for each company. However, in a sector that provides an essential public service, companies must be transparent about executive pay.

We 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.

Customers benefit where management incentives, including performance related pay policy, are appropriately aligned with the interests of customers.

We expect that policies for short and long-term performance related executive pay should 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.**

We recognise companies may need to amend their policies over time; we will look for a commitment in business plans that where **changes** are made, the reasons for changes, including how these take due account of the customer interest will be set out transparently in the Annual Performance Reports.

5.1 Consultation proposals – Performance related executive pay

We said we 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. We consulted on an expectation that companies should demonstrate how the performance related element of executive pay is appropriately aligned to delivering exceptional performance for customers.

Our consultation proposed that 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. We are proposing to assess this within our PR19 IAP assessment.

5.2 Consultation responses

All respondents apart from 6 commented on our performance related executive pay policy proposals. There was a broad acceptance of our proposals from the majority of respondents (25 out of 32 respondents were supportive, 6 made no comment and 1 disagreed).

Most respondents agreed with our proposals about the need for greater transparency of the performance related pay of executives and the link to exceptional delivery to customers. For example, some respondents commented that:

- Customers and wider stakeholders must have confidence in the companies' executive remuneration packages and they should be fully disclosing the remuneration of executives. Far greater transparency is critical and executive remuneration needs to be geared towards delivering long-term benefits to customers.
- The IAP assessment should assess the transparency and link between executive pay and delivery for customers.

Several respondents raised concerns with the proposal that payments for performance related pay should have a substantial link to exceptional delivery for customers, stating that:

- It will only work if it includes a basket of measurable objectives.
- "Exceptional" may be too high a threshold, and a sliding scale may be more appropriate.

- It should not be for Ofwat to determine what a benchmark of 'exceptional' is or what measures of 'performance' are adopted. This should be the responsibility of the board of each company.
- The reference to exceptional delivery for customers is flawed both in terms of scope and threshold.
- The definition of exceptional needs to be clear.
- Reference to exceptional delivery conflicts with corporate governance requirements that pay should adjust to reflect all performance.

Several respondents considered the proposals could have unintended consequences, in that they may force company boards to increase base pay and reduce performance related pay, which would be an outcome against customer interests. Some considered that restrictions to performance related elements of executive pay would reduce alignment between management and stakeholders, which were not considered to be in the 'best interests of the industry'.They also commented that if compensation policies were too restrictive in nature, it could result in retention risk and misalignment with shareholders and broader stakeholders.

One respondent, Consumer Council for Water, stated the companies should make commitments in their business plans to be transparent about executive pay, but also to demonstrate that the performance related element is linked to delivery of customer commitments and cost efficiency. Ofwat should intervene if the company fails to produce such a commitment in its business plan, or fails to adhere to this commitment.

One investor respondent stated that the facility for disclosure already exists e.g. in companies' annual remuneration reports, suggesting that the case for a parallel regime was not established.

5.3 Our assessment of the issues raised in the consultation

Given the essential services provided, it is important for customers and other stakeholders that companies in the water sector are transparent about how executives are remunerated and how performance related elements of pay relate to delivery to customers. Where policies are well designed, the incentives placed on management through performance related pay policies can appropriately align interests of directors with those of customers and investors. Transparency of the relationship between pay and performance can help customers see how performance related pay is appropriately aligned to the provision of an essential service.

Taking account of consultation responses, we have looked again at our proposal to assess performance related executive pay policies in the IAP. In doing so, we have considered the policies companies reported in their 2016-17 Annual Performance Reports. Our assessment of the disclosures on short and long term performance related pay reveals instances where companies focus on performance relating to financial metrics, rather than performance for customers. Companies could do more to be transparent about what element of performance related pay relates to service and performance delivery or how their policies take account of the customer interest.

The regulatory incentive mechanisms we put in place focus on delivering the best outcomes for customers. Our PR19 methodology increases the proportion of revenue (and so profits) at risk for cost or service performance and provides an opportunity for companies to consider how their performance related pay policies can contribute to this alignment of the customer and shareholder interest. By including an assessment of performance related executive pay policies in the IAP, we seek to increase company focus on these issues, and this inter-relationship, and encourage transparency.

Several respondents raised concerns with reference to “exceptional delivery for customers”. We have looked again at this. In doing so we reviewed the April 2016 UK Corporate Governance code as well as the FRC’s consultation on proposals for revisions to the UK Corporate Governance Code for the 2018 Code. The FRC’s UK Corporate Governance Code of April 2016 stated that ‘Performance related elements [of executive pay] should be transparent, stretching and rigorously applied.’

In a regulatory context, we use “stretching” usually to relate to performance that drives the sector forward, either because it is sector leading, or outperforms our benchmarks; we consider it is also relevant in the context of executive incentives to the extent that delivery of service to customers improves over time. We note, however, that stretching performance for companies that already perform well can be different to performance that is stretching for poorer performing companies. We conclude that exceptional may appear too high a threshold and therefore that, in the case of incentives placed on company executives, ‘stretching’ – meaning stretching by reference to the business plan – is a suitable test.

We will look for evidence in our IAP assessment that performance related pay policies demonstrate a substantial link to stretching performance for customers. We expect companies to set out in their business plans how stretching performance for customers will be delivered via their performance commitments.

We will look at the evidence companies set out in business plans that performance related pay policies are relevant to the public service nature of the sector. Our

assessment will recognise that it is for each company to be responsible for the design of its policy; Ofwat does not propose to design policies – rather we propose to assess whether the policies companies put in place take sufficient account of the interests of customers. Well designed policies will reflect operational performance for customers and so are likely to reflect ODIs, totex, or other aspects of operational performance and are unlikely to focus exclusively on financial measures such as cashflows. Measures taken into account may be different for each executive depending on their responsibility, and other factors may be relevant, for example, related to Health & Safety, the environment or other factors. We will also look for evidence that policies take account of factors that are relevant to the period over which the incentives apply, for instance if distinctions are drawn between short and long term incentives.

It is for each company to explain how its policy will be applied, including where relevant, the role and composition of any remuneration committees of the board. We will look for evidence about the company's commitment to rigorous application of its policy for 2020-25 in the business plan, identifying those companies that fall short in the IAP. We consider that the criteria of transparent, relevant, stretching and rigorously applied will help us to assess the policies companies propose in their business plans.

We note that the UK Corporate Governance Code was updated on 16 July 2018, after our decision on targeted changes to the PR19 methodology. While the Code now states that 'Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy", we are content that our criteria are consistent with the Code. We note the FRC's Guidance on Board Effectiveness (July 2018) refers to the role of the remuneration committee, and sets out questions for remuneration committees to consider, including (i) "How will any financial and non-financial performance measures support long-term thinking and delivery against strategy" and (ii) "What steps have we taken to make sure that any performance measures are stretching?"

We recognise that companies may need to amend their policies and approach over time. We will look for commitment in business plans that where changes are made, that the reasons for change, including how these take account of the customer interest, will be set out transparently in companies' annual performance reports.

We recognise also the concerns of some respondents that by increasing company focus on performance related pay policy in the IAP, our proposals could drive unintended consequences. However, we do not consider this a given and overall, we

consider that executive pay and performance incentives are matters for companies to determine and they should ensure that their policies overall are appropriate. As set out above, we consider performance related pay can be powerful in driving the right incentives on management, and to appropriately align the interests of company management and investors to the interests of customers for the delivery of an essential service. Our aim is to encourage companies to consider carefully the policies they have in place to ensure they incentivise the correct management incentives for the delivery of service to customers now and in the long term.

We consider it is appropriate to increase focus on performance related pay policies in business plan submissions and through our IAP assessment, to provide a stronger incentive on companies to increase focus on these issues at a point in time where the relationship between strategic and operational planning and expected performance should be crystallising. Therefore it is more powerful than if we relied on annual reporting requirements alone. Our decisions do not override the statutory duties of directors under the Companies Act.

6 Sharing financing outperformance

This section sets out our assessment on the principle of sharing financing outperformance for PR19 business plans. We summarise our consultation proposals, issues raised in response and our position taking account of the issues raised.

Sharing financing outperformance – summary of position

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.

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 intend to intervene to introduce a mechanism at draft determinations.

We propose an **illustrative mechanism** with a 10% deadband above the notional gearing level of 60%. The mechanism will trigger for companies with actual gearing levels of 70% and above. The mechanism will share 50% of the difference between notional nominal cost of equity and actual nominal cost of debt for the proportion of gearing that is above a reference point of 65%.

Gearing outperformance mechanisms proposed by companies in their business plans can differ from the illustrative mechanism if the alternative delivers equivalent benefits for customers in the round. Outperformance mechanisms could include a **transition period** where there is convincing evidence that this is in the customer interest. Our in the round benefit assessment includes both **financial and wider impacts** such as risks borne by customers.

Companies with gearing that is currently below the 70% trigger threshold should consider the steps they will take in the event that they carry out a future financial restructuring that increases gearing to levels above threshold.

We reconfirm our PR19 position that we encourage companies to develop benefit sharing arrangements related to **outperformance of the cost of debt** when it is in the interest of customers.

6.1 Consultation proposals

Our consultation looked again at the PR19 incentive mechanisms, to consider areas where the scope for outperformance appeared to be skewed in favour of investors and proposed steps that could be made to address the balance. The consultation set out the areas where companies can out/underperform in 2020-25 as a result of their financing decisions. These arise as a result of (i) high gearing relative to notional gearing and (ii) out/underperformance against the cost of debt.

Sharing outperformance associated with high gearing

The consultation set out that we considered there is a strong case for customers to share benefits from gearing levels that are high relative to the notional structure. We set out that:

- Equity investors in companies with gearing above the notional level benefit from higher returns, as company profits are shared across a smaller equity base.
- Companies with high levels of gearing have potentially lower levels of financial resilience, as the impact of cost shocks or poor performance is magnified on a smaller equity base.
- As it is companies and investors rather than customers that make choices about financial structure, despite the safeguards 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.
- Customers are paying for an allowed cost of capital under a notional structure, but investors can benefit from gearing levels that are higher than the notional structure without sharing any benefits with customers. The benefits of such arrangements are systematically skewed in favour of investors.
- We confirmed that our policy approach to tax for highly geared companies remained appropriate as it would continue to protect customers from paying too much.

Our consultation proposed that companies with high levels of gearing should propose outperformance sharing mechanisms in their business plans. We proposed to assess company proposals in our Initial Assessment of Business Plans, and, where sharing mechanisms did not adequately share benefits with customers, we proposed to intervene to impose a mechanism at draft determinations. We illustrated a proposed sharing mechanism in the consultation.

Sharing outperformance of the cost of debt

Our consultation highlighted the significant variation in cost of debt performance of the companies we regulate and so the scope for companies to out/underperform our cost of debt allowance. We discussed the relative merits of introducing an outperformance sharing mechanism as discussed in our September 2016 consultation on the approach to the cost of debt for PR19. We reconfirmed our PR19 position that we encourage companies to develop benefit sharing arrangements around the cost of debt when it is in the best interest of customers.

We said 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. We set out that we would not impose a cost of debt sharing mechanism as a consequence of our IAP assessment.

6.2 Consultation responses

All respondents apart from three commented on our financing outperformance sharing proposals.

CC Water, the Bristol Water Challenge Panel, Severn Trent Water, South West Water and United Utilities Water agreed or strongly supported that companies should propose mechanisms for sharing financing outperformance in their business plans and that this should be assessed in the IAP. South West Water noted that the principle of returning 'unearned gains' should be adopted. CC Water noted in particular that greater financial transparency and a share of the benefits when companies make gains from debt financing and higher gearing may help address the issues they referenced regarding the number of customers with concerns about fairness and value for money as well as a lack of trust.

Many respondents that submitted written responses to our consultation expressed disagreement with benefit sharing. Particular concerns were raised by companies with high levels of gearing, and their investors. This contrasted with meetings with investors in companies with gearing levels closer to the notional level, who did not express concerns with the proposals. Some equity investors supported the proposal as they thought it would be a basis for improving legitimacy and reducing political risks and some debt investors considered the proposals to be beneficial as they could limit their risk exposure by further disincentivising companies to increase gearing levels.

Many respondents commented that the proposal is a retrospective change or a change having retroactive effect which is inconsistent with good regulatory practice. A few respondents commented that our proposals are penal for companies with high levels of gearing, as long-dated finance is expensive to unwind and it takes time to reduce gearing, which may support the need for a transition period. One investor suggested highly leveraged companies cannot "turn on a tuppence" and so there is no time to implement changes for PR19. A few respondents raised concerns that this created regulatory unpredictability which increases the risk of investor exit, leading to a higher cost of capital and higher cost to customers.

Many respondents commented that no evidence has been provided that financing outperformance exists in the way described. They believed that our stated rationale for the changes was inconsistent with established economic and financial theory (citing in particular the Modigliani-Miller theorem). Some respondents commented that Ofwat had not clearly articulated the problem with highly geared structures and that the case for change had not been made. Some respondents expressed a view that the only benefit that comes from higher gearing is through the debt tax shield, but that this already benefits customers.

A few respondents commented that a detailed regulatory impact assessment should be completed before such a fundamental change in regulation is contemplated or implemented.

Several respondents raised concerns that our proposals cut across the long standing principle that companies, rather than Ofwat, are responsible for their capital and financial structure and shareholders bear any associated risk or reward. Respondents suggested this represented a fundamental shift away from the regulatory foundation of capital structure neutrality, risking “a crisis of confidence” in the stability of the sector and in the UK more broadly.

A few respondents raised concerns that focusing on financing outperformance will distract from the broader objective, which is the achievement of an overall better balance between the interests of customers and investors or that benefit sharing should be considered in the round.

A few respondents commented that the proposal would alter the risk and reward balance, which could increase the cost of capital. One respondent suggested that benefit sharing moves accountability for inefficient structures to the regulator, another suggested it makes regulatory decisions less transparent and more unpredictable, which will increase risk.

Design of a possible mechanism

Several respondents disagreed that notional gearing of 60% with a 5% deadband equates to a highly geared company. Some respondents commented that the expectation that 65% will be the threshold had no basis, suggesting it was lower than the level of gearing previously identified as causing concern[9]. Some respondents suggested that a deadband of at least 10% would be justified, on the basis that the gearing of the notional company will need to vary over the price review period reflecting issues such as the scale of investment programme. One respondent suggested it should apply at 67.5%; another respondent commented that 68% should reflect the top of a normal gearing range.

Several respondents considered that our proposals should only apply to a subset of companies where there are demonstrable issues and not unintentionally impact others. Two investor respondents commented there is a risk of unintended consequences that could alter the perception of the stability of UK regulatory structures among investors.

One respondent suggested that the gearing calculation underpinning the benefit sharing calculation should include pensions deficits to give proper incentives to companies to pay down deficits (as the impact of a pensions deficit would increase gearing for the purposes of the benefit sharing calculation).

Consultation responses did not raise concerns with the position we restated that we encourage companies to adopt voluntary sharing mechanisms for outperformance of the cost of debt.

6.3 Our assessment of the issues raised in the consultation responses

6.3.1 Introduction

In reaching our conclusions on this issue, we have reassessed the incentives on companies related to their financing choices. We have looked again at the relative power of the incentives that underpin the regulatory regime and the potential impacts

[9] For example, respondents cited the Jonson Cox's speech at the Water Industry City Conference on 1 March 2018.

of these incentives on the customers of companies providing an essential public service.

We have concluded that company decisions that increase gearing levels materially above the notional level are not appropriately aligned to the interests of customers. Where companies adopt high levels of gearing, they may increase risk to equity investors and reduce financial resilience, it also may transfer some risk to customers and or potentially taxpayers, in the event that a company fails. High gearing may also reduce the ability of companies to adapt to changes to regulatory arrangements that are required in customer interests. Equity investors benefit from higher equity returns that are associated with their increased risk, but there is no substantive benefit passed to customers. We consider it is necessary for us to take steps now, as delaying or deciding not to act now would lead to further dis-benefits to customers over the long term.

We have concluded that companies with gearing levels materially above our notional assumption should propose sharing mechanisms in business plans. We have however amended the illustrative mechanism proposed in our consultation to trigger only for those companies that have actual gearing levels that are 10% above our notional assumption10.

Further, companies can propose sharing mechanisms that differ from the illustrative mechanism we set out. Taking account of consultation responses, we will accept such alternative mechanisms if they deliver equivalent benefits for customers in the round, which may include both financial and wider impacts such as risks borne by customers. Alternative outperformance mechanisms may include a transition period where there is convincing evidence that this is in the customer interest.

In the rest of this section we:

- revisit the benefit sharing position set out in our 2016 cost of debt consultation in section 6.3.2.
- set out our views in response to the issues raised by consultation respondents on economic and corporate finance theory in section 6.3.3.
- set out our views on the mechanics of a default sharing mechanism in section 6.3.4.

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[10] The notional gearing assumption that underpinned our early view of the cost of capital for PR19 was 60%. Our policy means that benefit sharing would trigger only for those companies that report gearing of 70% or more.

- set out how we will assess company proposals in section 6.3.5.
- set out our views in response to the issues raised by consultation respondents of the impact of the proposed mechanism on the investibility of the sector in section 6.3.6.

6.3.2 Revisiting the benefit sharing position in our 2016 cost of debt consultation

In our cost of debt consultation in 2016, we noted that we had decided not to propose to adopt a different approach for highly geared structures for PR19, taking account of the evidence at the time. Our judgement at the time took account of a number of factors including:

- The financial benefit some customers receive because of our policy approach to tax;
- Work undertaken for us by PwC in 2013, identified potential concerns with highly geared structures. However, at that time, based on a high level review, PwC argued highly geared structures did not necessarily present a higher risk to customers, but suggested that this may change in the future, and so recommended a financial monitoring regime should be established to better understand risks and ensure visibility be improved over time.

Since we published our cost of debt consultation in 2016, we have initiated a financial monitoring regime. Our financial monitoring report in 2017 signalled that we expect companies to consider how changes to the allowed cost of capital for PR19 might impact on their financing arrangements, and whether there is a need to make changes to their capital structures and financing arrangements to address the impact of this rather than waiting until the start of the next control period in 2020.

We set out in section 6.3.3 our view that company decisions on financing are distorted as they benefit from higher returns from gearing up, while there is little incentive to consider customer interests, but first we revisit our previous position on tax and the risks of highly geared structures in the sections below.

Revisiting tax

In 2016, we set out that customers can benefit from highly geared structures as a result of our policy approach to tax, as the tax allowances calculated in price determinations are calculated on the basis of the actual financial structure where gearing is above the notional assumption and we claw back, at a subsequent price review, tax benefits where a company increases its gearing levels. This was raised

by a number of respondents to the consultation as part of a justification for taking no action now. In reassessing these issues we note:

- Our policy approach to tax was put in place at PR09 to remove an incentive on companies to increase gearing purely to benefit from tax allowances we remunerated in price setting; the policy was not designed to provide financial benefits to customers.
- The Green Book advises that tax be excluded from the overall monetised estimate of a policy's value because it is a transfer payment where costs are offset exactly by benefits.
- Overall, for companies on average, at PR14, tax amounted to 1% of total revenues. Tax comprises a small part of the overall bill, and in the case of one of the highly geared companies, the availability of capital allowances mean that the allowance for tax was zero at PR14. We assess that it would have remained zero if the company had adopted a notional financial structure.
- Financing decisions are matters for companies and their investors; gearing levels are not decided by customers. Companies have material control over gearing levels which impacts on the tax costs remunerated in price controls.

Our view remains that the policy approach to tax, as set out in our PR19 methodology remains appropriate as it avoids providing an additional incentive for companies to increase gearing. However, this does not address the concern that there are other incentives for companies to adopt high levels of gearing, in particular the increased returns that may be available and which are not shared with customers.

For the reasons set out above, we consider that any benefits customers receive for lower tax allowances as a result of a companies' choice of capital structure should not be seen as a direct benefit against which this revised approach to sharing financing outperformance should be assessed. However we do quantify the distributional effects alongside our assessment of impacts in Appendix 2, which we consider to be small.

Revisiting the risks of highly geared structures

Since PwC undertook its high level analysis, we have implemented a financial monitoring regime which among other things has enabled us to better test and assess financial resilience. This has enabled a better understanding of the greater risks in terms of resilience of highly geared structures and their more limited ability to adapt to changes in the regulatory framework such as from a lower cost of capital and tougher cost efficiency challenge. This evidence includes:

- Since 2016, we have reported on financial resilience in our Monitoring Financial Resilience reports. In our 2017 report we set out that we expect companies to be thinking about how changes to the cost of capital might impact on their financing arrangements in the next price review period. Since our cost of debt consultation, we have seen evidence of companies taking steps to amend existing financing arrangements to improve financial resilience, for example by refinancing swaps, injections of funds and refinancing of debt.
- Our final PR19 methodology, which included a lower cost of capital than for previous price reviews and an approach that puts more revenue at risk to incentivise companies to focus more on what matters for customers, means that companies, particularly those that are highly geared, need to look more carefully at financial resilience. Our early view of the cost of capital included a lower level of gearing to account for these risks; it is also relevant for highly geared companies to consider the impacts on their actual financial structures. Lower levels of equity finance mean there is less headroom for downside risk or for managing greater revenue volatility.
- On 19 December 2017, Moody's changed three water companies to negative outlook and affirmed two others as negative outlook as Moody's considered these companies most exposed to the likely cut in returns as a result of the PR19 methodology. On 15 January 2018, Moody's changed the UK Regulated Water Utilities sector outlook to negative, indicating their expectations for the fundamental business conditions over the next 12-18 months, quoting a tough price review outweighing current performance and while companies will review their financial and dividend policies in light of the lower returns, some may ultimately be unwilling or unable to maintain credit quality.
- On 30 January 2018, Standard and Poor's stated that water companies across England and Wales will find aspects of the new pricing methodology challenging, with companies particularly affected by the reduction in the allowed cost of capital and introduction of more rigorous benchmarks on cost efficiencies and service performance. One water company has a credit rating of BBB, one notch above a minimum investment grade rating.
- Following a review of the long term viability statements that companies published in 2017, we identified significant inconsistencies in the level of detail provided by companies and in most cases the information provided did not fully explain the procedures that had been followed. We subsequently issued an Information Notice with the aim to ensure all companies apply and demonstrate appropriate rigour in assessing financial resilience. Such rigour is important if highly geared companies are to demonstrate and give stakeholders confidence that their financing structures are robust.

- Some of the highly geared companies have recently experienced significant performance issues such as leakage and supply interruptions.

All of the above issues have led us to question whether our approach to highly geared structures is sufficiently delivering in customers' interests.

6.3.3 Economic and Corporate Finance Theory

Several respondents to our consultation raised concerns that our benefit sharing proposals cut across accepted economic theory that cost of capital is invariant to gearing levels. According to the Modigliani-Miller theorem[11] provided certain conditions hold true, the level of gearing does not affect the value of the firm or its systematic risk, and thus capital structure is irrelevant to the value of a firm or its cost of capital. The objection of respondents is that this implies that there are no "benefits of high gearing" to share with consumers.

We consider that these arguments reflect a misunderstanding of the implications of the theorem. Far from cutting across the theorem, our proposals reflect its practical application. The theorem needs to be seen by what it was designed to illustrate, the benefit of refocusing the attention of management away from financial engineering ("slicing of the pizza" as the authors often referred to it) towards activities that truly grow a business.[12]

The theorem relies on assumptions which are not present in the real world. As the authors themselves acknowledged, the attraction of the theorem is not in saying that in an idealised world capital structures do not matter, but in turning it on its head and studying systematically why in the real world capital structures do matter. It suggests that the real source of company growth is not in financial engineering but in value enhancing business activities.[13]

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[11] Modigliani, F.; Miller, M (1958) The Cost of Capital, Corporate Finance and the Theory of Investment', Economic Review
[12] For instance a 1997 interview with Merton Miller (https://www.ifa.com/articles/An_Interview_with_Merton_Miller/) or Michael S Knoll's review of the theorem: "The Modigliani-Miller Theorem at 60: The Long Overlooked Legal Applications of Finance' s Foundational Theorem", University of Pennsylvania, 2017.
[13] Ibid.

Respondents put forward other comments on our consultation with respect to risks associated with higher gearing.

One comment was with respect to the treatment of tax. The Modigliani-Miller theorem assumes no tax, but our policy approach assumes no benefit for tax because we remunerate tax allowances based on the actual financial structure where it is greater than the notional level. We agree that in the water sector, our policy approach to tax means that companies are not able to drive returns by leveraging up to outperform their tax allowance for the ringfenced company.

A number of respondents argued that higher equity returns from gearing far above the notional level were justified by the increased risk from such arrangements. We address the question of whether equity holders do in practice bear all of this increased risk below. However, we note that even if equity holders were bearing all of the increased risk, we still consider there are significant questions about how the interests of customers are taken into account in such arrangements. Indeed, it is far from obvious how customers benefit in any way from investors using complex financing structures to significantly increase their returns and risk. Therefore, we consider that our proposed benefit sharing arrangements help to address this, and as with our other incentive mechanisms, seek to better align investor and company interests with those of their customers.

The fundamental point behind many of these responses was a suggestion that companies could not increase their gearing beyond our notional level without incurring offsetting risk. We note that increasing gearing above the notional level, may (i) increase the probability of default, increasing risk to consumers of service interruption and/or (ii) increase pressure from bondholders to restrict future cash outlays thereby creating pressures which may limit, for example, future investment. Both of these issues result in potential consumer detriment, but neither necessarily cut across the Modigliani-Miller theorem.

In a competitive market, a firm that made its consumers bear such additional risks (either of lost service or of foregone quality improvements) may be more likely to lose customers to other competing suppliers. In the context of monopoly service provision, encouraging companies to consider the impacts of their decisions on customers is consistent with the reason we provide controls on revenue – because such constraints would apply in a competitive market.

Increasing gearing well above the notional level could have other effects, including to (i) increase the likelihood of future financeability issues, and (ii) increase the perceived likelihood of triggering price control re-opening mechanisms where firms

seek to increase funding where a firm is in financial distress, given our financing functions duty.

These factors may increase future expected cashflows (because of a perceived opportunity for additional revenue in distress scenarios) and they might be perceived to reduce exposure to systematic risk (because investors may perceive that in the case of downside shocks that risks are more likely to be borne by customers). There is the potential in both of these cases for the assumptions that may underpin capital structure choices to cut across the Modigliani-Miller theorem, the first because expected revenue might be expected to rise with gearing, the second because exposure to aggregate systematic risk may be perceived to reduce with higher gearing.

In theory, regulatory mechanisms in place that include the regulatory ring fence, and special administration could help protect customers from the risk transfer of highly geared structures. However while these features of the regulatory regime help to protect customer interests, they are not perfect . For example, some risks can remain with taxpayers or customers. Experience indicates these costs can be large[14] and special administration is not a costless process as longer term planning and investment can be disrupted during the transition of a special administration process. So even if customers do not bear much of the risk of immediate business failure, some costs may ultimately fall on customers.

Such real world factors may encourage regulated monopolies to increase gearing, and in so doing, transfer some risk to equity investors, but also to customers or taxpayers at their potential expense. This underlines the importance of companies taking account of customer interests in financing decisions and, as we now consider, to be prepared to share the benefits of these arrangements with customers.

Some respondents considered there could be benefits from adopting the features of highly geared structures in our assumed notional structure. For example:

- One respondent suggested that if the implication of our policy was that a consequence of securitised structures was that they delivered a lower overall

[14] For example, in 2004 former Rail Regulator Tom Winsor put the overall cost of the government's decision to put Railtrack into administration at £11-14 billion; and in 2009 the National Audit Office estimated that the failure and entry into administration of Metronet in 2007 led to a direct loss to the taxpayer of £170-£410m

cost of capital, then setting price controls by reference to higher levels of notional gearing would be most beneficial to customers.
- Some respondents suggested covenants adopted by companies with highly geared structures reduce agency costs as they limit risks associated with management making decisions that are in their own interests rather than those of providers of finance. It was suggested for example, that securitisations may prevent risky spend, limit risky activities and help ensure financial resilience.
- Some respondents suggested that such covenants can benefit debt investors by increasing the risk to equity, highlighting for example that reserve and liquidity facilities typically are greater for highly geared structures.

We do not consider these arguments to be relevant to our proposals. We set our price determinations on the basis of a notional financial structure for a company that is efficient. Our aim is to encourage companies and their investors to consider the effect their actions may have on customers when adopting capital structures that are materially above the notional level. We note that adopting a higher level of notional gearing does not materially lower the cost of capital under conventional CAPM approach to setting the cost of equity, so there may be little benefit to customers from adopting a higher notional gearing assumption.

Some respondents considered that our proposals increased the cost of capital, for example, through an increase in regulatory risk. These views were expressed, in part, because our proposals were made after publication of our final methodology, giving rise to the perception that the regulatory regime is less predictable, but also a perception that Ofwat was moving from its previously held views that capital structure is a matter for companies and their investors. We disagree. The trigger point for the mechanism we propose is specific to those companies with gearing levels that are materially above the notional structure on which we base our cost of capital, it does not impact on systematic risk.

We note that a number of companies have withdrawn significant amounts of equity from the sector through the adoption of highly geared structures (we estimated this to have exceeded £9 billion[15] by 31 March 2010 for example – but we note there has not been significant refinancing since then). So highly geared structures have been

[15] Ofwat, 2010, Financeability and financing the asset base – a discussion paper

used to reduce equity investment in the sector, rather than increase investment for the benefit of customers.

The steps we are taking aim to help put the sector in balance not by interfering directly in capital structures, but by tackling the incentives on companies to increase their gearing when only they may benefit from the higher returns this can generate. We set out in section 3 the engagement we have had on these issues over the past year; we consider it is necessary to take these steps now, after publication of the PR19 methodology to ensure the regime is better aligned to protect the interests of current and future customers. We encourage companies and their investors to consider carefully the impact their financing and capital choices have on customers who pay the bills from which shareholders returns are derived.

6.3.4 Mechanics of the sharing mechanism

We have considered the views of respondents to our consultation provided on the design of the mechanism. Respondents commented predominantly on the gearing level at which the mechanism should be triggered and different views were offered. Predominantly, views expressed were that the deadband we proposed was too low, such that it was below a level that may be identified as causing concern and as such may drive unintended consequences.

Taking account of respondents' views, we consider there are merits in adjusting our proposed 5% deadband, as it may capture some companies that are not materially above the notional gearing level, due to expected fluctuations around notional gearing over a price review period. We propose to amend the mechanism to incorporate a 10% deadband (and so a gearing trigger for benefit sharing at 70%). This will limit consequences on companies with gearing closer to the notional level and impact only on those companies that are materially above notional gearing. However, to ensure adequate benefits are shared with customers, we maintain 65% as the reference point for benefit sharing calculations (once the 70% trigger has been passed).

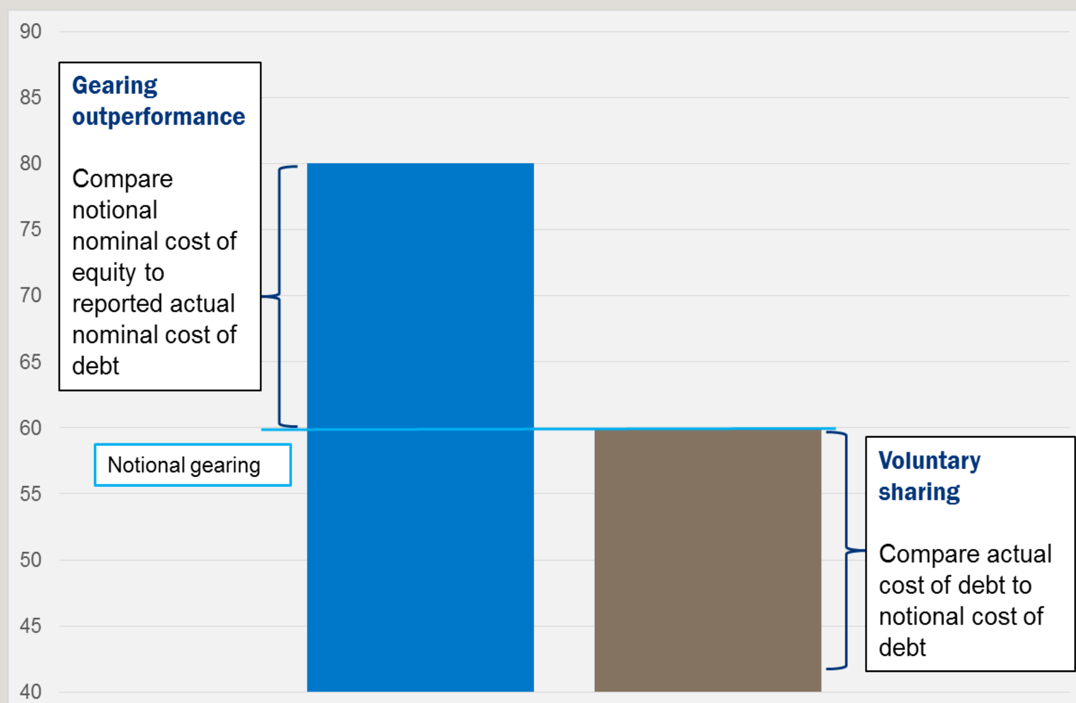
The introduction of a benefit sharing mechanism brings increased focus to the definition of regulatory gearing. The gearing we require companies to report in their Annual Performance Report focusses on borrowings. It specifically excludes some items that might be included in covenanted gearing calculations, such as pension deficits. We expect the mechanism to follow the definition of regulatory gearing. We note one respondent argued that pension deficits should be included in the calculation of gearing for the purpose of benefit sharing. However, we consider the definition of regulatory gearing should be consistent with that adopted for setting the

notional cost of capital and for measuring regulatory gearing. Companies should take account of pensions deficits in considering their financial resilience and as we discuss above, in setting dividend policy. We do not propose to change our definition of regulatory gearing to include pensions deficits.

Respondents that commented on the detailed nature of the calculation either supported our proposal that calculations should be on a nominal basis, or stated they did not have a preference. A mixed view was expressed on the basis of whether the calculation should be underpinned by the actual or notional cost of debt. We retain our view that the calculation should be underpinned by the actual achieved cost of debt as there is likely to be some link between the achieved cost of debt and the actual gearing level.

We illustrate why we consider actual rather than notional cost of debt should be used to underpin the gearing mechanism in figure 4 – the illustration draws out the difference in the calculation that may occur compared with a company that adopts a voluntary cost of debt mechanism. We then illustrate our default mechanism in figure 5.

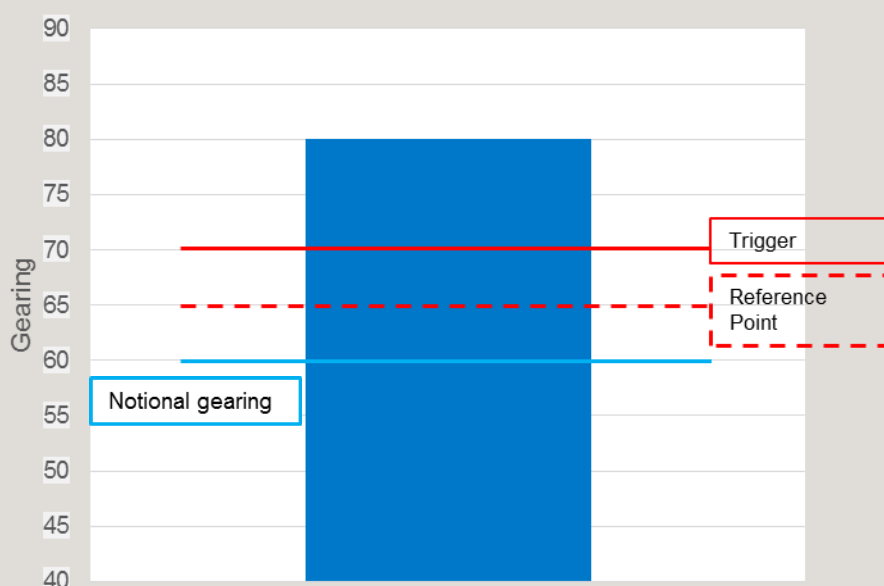
Figure 4 - Rationale for using the actual cost of debt to underpin the benefit sharing calculation for companies with high gearing



Where gearing exceeds the notional level, companies may have replaced equity with debt. Outperformance therefore compares the allowed cost of equity with the achieved cost of debt for the proportion of gearing that is above the reference point.

A voluntary sharing mechanism for cost of debt outperformance must compare the achieved cost of debt with the allowed cost of debt.

Figure 5 - Benefit sharing mechanism for high gearing – default mechanism



Mechanism triggers where actual reported gearing exceeds 70% for each year of the price control period

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

Where:

Gearing difference = Actual gearing – Reference point

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

Where:

Actual gearing is as reported in the Annual Performance Report

Reference Point = 65%

Financing outperformance is calculated in nominal terms. The notional nominal cost of equity is stated in the final determination. The actual nominal cost of debt is as reported annually by companies in the Annual Performance Report.

Sharing rate = 50%

Some respondents to our consultation raised concerns that companies cannot reduce gearing levels quickly in response to the benefit sharing mechanism. We recognise this may be the case. We note however that:

- There is no requirement for companies to adjust financial structures in response to our mechanism. Any adjustment to financing structure is a matter for companies and their investors to determine.
- Some companies have separately made commitments to reduce gearing from current levels through 2020-25 – to the extent that they choose to reduce gearing levels, this will reduce the value of any benefit sharing adjustment.
- Even if companies consider it is appropriate to adjust financial structures in response to the benefit sharing mechanism, the incentive mechanism would not take effect until 2021, providing companies over two and a half financial years from the publication of decision in which to do so. And, while companies may propose to share benefits during 2020-25, any mechanism we impose would not have any cashflow effect until 2025, when reconciliation adjustments would be made. This means we are not clawing back past investor gains.
- In our early view on the cost of capital in our PR19 methodology, we assume around 30% of debt is financed, or refinanced, in a review period. The current highest level of gearing in the sector is 83%. Our proposed deadband to gearing at 70% would imply that the replacement of significantly less than 30% of debt would be necessary even for the most highly geared companies to align with the deadband over the course of a price control, if that is what relevant companies chose to do. Where investors can provide additional equity and the debt portfolio consists of debt with a range of maturities that is consistent with the notional assumption that underpins our cost of capital, companies can adjust their financing arrangements within the thresholds of the sharing mechanism without refinancing debt, again if that is what companies wish to do.

One respondent suggested that our proposed mechanism moves the accountability for inefficient structures to the regulator. We note however that companies retain the full flexibility to choose their financing and capital structures. Put simply, where high gearing is considered prudent and beneficial, both customers and investors will

benefit from the arrangements going forward. However, as it is companies that make choices about their structures, it is companies rather than customers that continue to bear the risk associated with their choice. Further, as set out in section 6.3.5, companies can put forward alternative mechanisms in their business plans that provide equivalent benefits, in the round, to customers.

6.3.5 Transition and 'in the round' assessment

Companies can propose their own mechanisms in their business plans, and in doing so, we expect companies to consider carefully whether their approach to the mechanism takes due account of customer interests. We will accept such alternative mechanisms if they deliver equivalent benefits for customers in the round as those in our default mechanism set out in section 6.3.4. These benefits could include both financial and wider impacts such as reduced risks to customers.

We accept there may be, in some circumstances, reasons why it may be beneficial to adopt a transition period. We clarify that alternative mechanisms could include a transition period where compelling evidence is provided that it is in the customer interest. However it will be important that the overall proposals deliver benefits that are equivalent to the default mechanism.

Since our consultation closed, three companies, Anglian Water, Yorkshire Water and Thames Water proposed an alternative benefit sharing mechanism. We have published the letters in which these mechanisms were proposed. We set out our assessment of the proposed mechanism below.

Alternative sharing mechanism proposed by Anglian Water, Yorkshire Water and Thames Water

Since our consultation closed in May, Anglian Water, Yorkshire Water and Thames Water wrote to us to propose an alternative mechanism. The full detail of the mechanism they propose is stated in the bullets below:

- Ofwat's final methodology already includes an automatic sharing of some benefits by setting an allowance below the trailing market rate for new debt.
- We would propose to go further than that and introduce a new mechanism for AMP 7 that shared with customers outperformance of the allowed cost of new debt.

- For AMP 7, such a mechanism would be asymmetric, so as not to put customers at risk of companies failing to raise new debt efficiently during this period, whilst retaining an incentive on companies to raise debt efficiently.

- The mechanism would be reviewed as part of PR24.

Ofwat's assessment of the proposed mechanism

The PR19 methodology already includes a cost of debt mechanism, and we take some account of the fact companies outperform benchmark data both in the cost of new debt and the cost of embedded debt. The proposed mechanism does not appear to deliver any additional benefit to customers; rather it could reduce the incentive on these companies to outperform the cost of debt.

No evidence has been provided that the proposed mechanism will provide benefits to customers that are equivalent in the round to those provided by our mechanism. Further, the mechanism does not address the issues around high gearing, high equity returns and the risks around these arrangements and the need to appropriately align investor and management interests with those of customers in setting financing structures.

6.3.6 Investability

A few respondents assert that introduction of our policy now, after publication of the PR19 methodology, increases the risk of investor exit, and could lead to unintended consequences. They suggest it would reduce the attractiveness of water infrastructure by altering the stability of UK regulatory structures among investors and potential investors in other utilities.

These views are contrary to the evidence we see in our engagement with investors and evidence that companies continue to trade at premia to RCV. Since publication of our consultation, equity research published by Morgan Stanley has argued that our proposals may improve the investability of the sector in the long-run by improving

the sector's perception[16]. Royal Bank of Canada's equity research unit has also stated that they are encouraged by our consultation proposals.[17] Morgan Stanley have also stated that observed average UK water premium to Regulatory Capital Value of 10% is broadly in line with the long-term UK water average since 2005 of 11%[18]. We note, in particular, the attractions investors continue to cite of investments in a regulated water sector, a sector that is underpinned by inflation linked returns, regulatory commitments to incentive mechanisms put in place and the RCV, and where economic regulation is independent of Government.

We note that, since publication of our consultation two credit rating agencies have revised their assessment of the business risk of the water sector:

- On 22 May 2018, Moody's announced revised ratio guidance for the water sector, such that a UK regulated water company would have to exhibit slightly lower gearing and stronger interest coverage to maintain the same credit quality[19].
- On 5 July 2018, Fitch announced they have lowered the gearing rating sensitivity by 3% and increased post maintenance interest cover (PMICR) by 0.1x for the upcoming price control.[20]

In both cases, the revisions were said to reflect increased business risk due to two issues:

- A tougher regulatory package for PR19, with a lower cost of capital and an incentive regime which puts more revenue at risk related to service delivery and cost efficiency.
- A modest perceived reduction in the long-term predictability of the regulatory framework associated with our benefit sharing proposals and greater scrutiny of dividends.

We consider that, in response to these issues:

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[16] Morgan Stanley Research, 'UK Regulated Utilities: Lower Return and Lower Risk', May 3 2018
[17] RBC European Utilities, 'European Utilities Morning Lightbulb', July 16 2018
[18] Morgan Stanley Research, Severn Trent, May 24 2018
[19] Moody's Investor Service, Regulator's proposals undermine the stability and predictability of the regime, May 2018
[20] Fitch Ratings, press release, Fitch revises outlook on 3 UK water holding companies to negative, July 2018

- Our early view of the cost of capital already acknowledged the increased levels of revenue at risk. Our early view cost of capital was underpinned by a lower notional gearing level than for PR14. Furthermore, we had already signalled[21] that companies should be thinking about how changes to the allowed cost of capital might impact on their financing arrangements, and whether there was a need to make changes to capital structures and financing arrangements ahead of 2020. Companies and their investors are responsible for their own financing arrangements, to ensure they remain financially resilient through 2020-25 and beyond. Rating agencies have acknowledged that a number of companies have been adjusting their financial profiles to get into a better starting position for PR19.
- We consider the steps we are taking, which focus on increased transparency of dividends and performance related pay, and which encourage companies to carefully consider the effects of their capital structure choices on customers, will help to increase trust and confidence in the sector. Indeed, some equity investors supported the proposal as a basis for improving legitimacy and reducing political risks and some debt investors considered the proposals to be beneficial as they could limit their risk exposure by further disincentivising companies from increasing gearing levels. We recognise the targeted changes we are making are after publication of the PR19 methodology, but as noted elsewhere in this document, there is a need for us to take steps now to put the sector in balance, to help secure trust and confidence in the sector for the long term.

[21] Ofwat, Monitoring financial resilience, November 2017[22] These companies are: Affinity, Sutton & East Surrey, South East, Anglian, Southern, Thames, and Yorkshire

7 Amendment to IAP assessment – securing trust, confidence and assurance

This section sets out our conclusions on revisions to the IAP test on confidence and assurance. We summarise our consultation proposals, issues raised in response and our position having taken into account the issues raised.

Revisions to the IAP test – confidence and assurance

Having considered the response to the consultation we have decided that, as we previously proposed, the transparency IAP question will be amended to include the 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)?

7.1 Consultation proposal

The proposals we set out in our consultation are issues that matter to customers and that impact on the trust and confidence customers and wider stakeholders place on the sector. Accordingly we proposed to rename the securing confidence and assurance test area to include the issue of "trust", hence - 'securing trust, confidence and assurance'.

We proposed to amend the test question to explicitly include within its scope an assessment of outperformance sharing, dividend policies and performance related element of executive pay.

7.2 Consultation responses

Of the respondents, 7 agreed with our proposals, 13 agreed but with suggested revisions, 10 did not comment, and 2 disagreed.

A few respondents suggested alternative wording for the proposal, either in response to the consultation, or in correspondence to us subsequent to consultation close. These included:

- Removing reference to “which include outperformance sharing, dividend policies and any performance related element of executive pay”.
- Emphasising the voluntary nature of the considerations by adding 'including' through appropriate measures and 'may' include outperformance sharing.

Several respondents commented that the scope of the test should not reference gearing outperformance and that the test should also take account of past performance for relevant areas. One respondent commented it was unclear why a “customer benefits test” is relevant where higher dividends are paid, since customer rewards and benefits are managed effectively through other regulatory mechanisms (totex sharing mechanisms and ODI rewards). The respondent considered that sharing “out-performance” at the levels referenced would result in a second layer of sharing and devalue the existing sharing mechanisms in place.

The Pensions Regulator strongly supported the proposal that IAP assessments should assess both the transparency of companies’ dividend policies and how it takes account of factors which include employee interests (including pensions).

Other comments made by respondents included that:

- The IAP assessment should be based on the clarity and transparency of companies’ policies, rather than the substance.
- The assessment should recognise the importance of understanding the overarching goals and demands made by holding or parent companies, including that in some sectors private equity firms demand a rapid return on investment.

7.3 Our assessment of the issues raised in the consultation

Our IAP incentivises companies to produce high-quality, ambitious and innovative business plans. It will assess business plans against nine key test areas.

As set out in the earlier sections of this document, we consider the steps we are encouraging companies to take on dividends and performance related executive pay are important for bringing the sector into balance. Our PR19 methodology already requires business plans to enable customers’ trust and confidence through high levels of transparency and engagement on issues such as the company’s corporate

and financial structures and we have given further clarity on the scope of this IAP test ahead of business plan submissions.

We consider our benefit sharing proposals are also important to restore trust and confidence in the sector and so we intend to test for them in the IAP.

We confirm that the decisions we have set out in sections 4 to 5 will apply on a forward looking, prospective basis. We do not propose to assess historical dividend disclosures, historical performance related executive pay policies or payments, benefit sharing or cost of debt outperformance sharing in this IAP test.

We acknowledge our regulatory mechanisms, including totex cost sharing and ODIs, seek to appropriately align shareholder returns and customers interests. We would agree that any benefit sharing arrangement does not duplicate or cut across existing mechanisms for sharing benefits such as totex cost sharing. But we consider that the issues we have identified throughout this paper and that continue to be highlighted by stakeholders demonstrate there is more to do. Our proposals aim to incentivise greater alignment through financing outperformance mechanisms (as well as through other aspects that reflect company performance: dividends and performance related executive pay). We consider it appropriate to use the IAP assessment to encourage companies to do this.

As illustrated in Figure 1, sharing the benefits of high gearing does not duplicate any of the regulatory incentive mechanisms already in place, nor do we consider it devalues the existing regulatory sharing mechanisms. Our aim is to encourage companies to take greater account of customer interests.

Our overall assessment of the trust and confidence test will be made in the round, taking account of any voluntary cost of debt outperformance mechanisms and wider factors that enable customers' trust and confidence including others set out in our PR19 methodology, for example, transparency and engagement with customers on issues such as companies' corporate and financial structures.

8 Financial resilience

This section sets out our expectations for our assessment of financial resilience in PR19 business plans. We summarise our consultation proposals, issues raised in response and our position having taken into account the issues raised.

Financial resilience – summary of position

Consistent with the requirements of the PR19 methodology, companies should set out evidence of their financial resilience, based on their actual financial structure, for the period 2020-25 and beyond. This should demonstrate how financial resilience will be maintained, taking account of the overall assessment of risks faced by the company. This should include risks related to capital structure as well as the impact of potential cost shocks arising from, for example, underperformance against plan or from additional financial liabilities which are not funded by customers. In all cases, we expect companies to be transparent about their ownership, control and financing structure.

Companies should model their own scenarios based on severe, reasonable and plausible scenarios for key variables to support their assessment, building on the long term viability statements that are included in Annual Performance Reports. Companies should also model a minimum suite of scenarios that are prescribed by Ofwat.

The suite of common scenarios:

- Totex underperformance (10% of totex) over 5 years.
- ODI penalty (3% of RORE) in one year.
- Inflation (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.
- Debt refinanced as it matures, with new debt financed at 2% above the forward projections.
- Financial penalty – equivalent to 3% on one year Appointee turnover.
- Any relevant intercompany financing scenarios.
- Combined scenario - underperformance of 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.

Where companies consider that any of the above common scenarios (including the combined scenario) are not relevant to their circumstances, we expect companies nonetheless still to model the scenarios and explain, with supporting evidence, their view about the relevance of the scenario and the basis on which financial resilience will be maintained. This may include mitigating actions the company has in place to prevent the scenario occurring and the planned management actions should the scenario arise. It may be relevant for the company to also provide alternative scenarios. The key point is that, in all cases, companies should explain the basis on which financial resilience will be maintained.

8.1 Consultation proposals

Our consultation included proposals clarifying our expectations regarding companies' approach to financial resilience in their business plans.

The consultation recognised that the factors that affect a company's financial resilience will likely vary for each entity. Each company is responsible for determining the appropriate level of stress testing, having regard to the principal of short and longer term quantified risks, to demonstrate that it maintains its financial resilience over the longer term. We proposed that companies should model 'severe', 'reasonable' and 'plausible' scenarios for key variables to support their assessment of financial resilience building on the company's long term viability statement set out in its 2018 Annual Performance Report and an expectation that companies should clearly explain why they consider their approach to be appropriate.

We set out, and asked for views on, a suite of common scenarios we expect companies to assess, along with a combined scenario. We explained that these scenarios were not an exhaustive list and that, where appropriate, companies should include further scenarios having regard to their consideration of all the principal risks specific to their circumstances.

We explained that we expect companies to clearly set out the impact of the stress tests on their ability to maintain financial metrics and their credit rating, and their ability to service debt, along with mitigating actions they will take if the results of the above scenarios indicate that the company's finances will not remain sufficiently resilient, or set out the reasons why they consider that the situation will not arise.

Our consultation set out that the board of each company should provide a statement in the business plan that the company is financially resilient and demonstrate how it has assured itself that this is the case.

8.2 Consultation responses

22 respondents commented on this element of our consultation.

Most respondents commented that they agree with the need for the sector to be financially resilient and that it is the responsibility of the company to demonstrate this. Six respondents agreed that including a standard suite of scenarios is useful to facilitate comparison of companies.

Ten respondents expressed disagreement with a standardised suite of scenarios. Concerns were expressed that it should be up to each company to specify the scenarios and level of risk appropriate to their circumstances, that the tests go beyond what is needed for a company to perform their risk assessments or that the tests duplicate, in part, the role played by credit rating agencies. One respondent commented that the imposition of common scenarios contradicts the role of the company to assess financial resilience based on company specific risks; another argued Ofwat had presented no evidence in support of the proposed scenarios.

Concerns were raised by a number of companies, including those that agreed with a common suite of scenarios, that the scenarios proposed were too extreme and highly unlikely to occur. One respondent considered few companies would be resilient under the proposed scenarios. Three companies proposed alternative stresses for some of the tests. One respondent raised concerns about how the parameters specified will be interpreted by stakeholders (including board members, customers, credit rating agencies and debt capital providers).

One respondent argued that the applications of these stress tests should be informed by the mitigations already in place to prevent such impacts materialising.

One respondent commented that the proposed scenarios do not align to those in the Business Plan guidelines for the assessment of impacts on the notional structure through the assessment of Return on Regulatory Equity.

One respondent raised concerns about the requirement to provide assurance about the assessment. The respondent considered such assurance would not provide good value for money.

In their response to the consultation, CC Water state that they would expect Ofwat to intervene if a company has either failed to present the scenarios, or their proposed mitigations are inadequate.

8.3 Our assessment of the issues raised in the consultation responses

Our aim is for companies to improve the transparency of their statements on financial resilience, both in terms of annual reporting and in demonstrating that business plans will maintain financial resilience in the long term.

Company boards are responsible for ensuring their company is financially resilient and we expect each company's board to be able to demonstrate how it has assured itself that this is the case when business plans are submitted. We consider it is necessary for companies to demonstrate in their business plans how they will, under a range of potential scenarios, continue to finance their operations and planned investments and to explain the steps they intend to take to maintain financial resilience for the duration of the price control and beyond. This is different to the role of the credit rating agencies in carrying out their assessment of a firm's credit worthiness. Indeed, the functions of the credit agencies are not an adequate substitute for the scrutiny Ofwat expects companies to undertake themselves, which is one of the best protective measures a company can take to maintain financial resilience. We would not expect company boards to rely solely on meeting credit agency metrics to determine that they are financial resilient.

Again, it is up to company boards to determine the level of assurance required in order to provide the statement in their business plan that the company is financially resilient. The business plan should set out the level of assurance obtained and explain why the board considered the level appropriate, taking account of issues it considers relevant, which may include its assessment of value for money.

Our assessment of companies' Long Term Viability Statements in their 2017 Annual Performance Reports revealed significant inconsistencies in the level of detail provided by companies; in most cases the information did not fully explain the processes that had been followed. This led us to issue an Information Notice which sought to increase the focus of companies on the issue of financial resilience in Annual Performance Reports for 2018 and beyond. We consider it is also necessary for companies to increase their focus on the issue of long term financial resilience for their business plan submission. We will highlight, through our IAP assessment, those companies we consider are falling short in terms of demonstrating their financial resilience.

Companies should determine the appropriate level of stress testing to demonstrate that they are financially resilient over the longer term and clearly explain why they consider their approach to be appropriate. The additional use of a common suite of scenarios allows us to draw better comparisons of company approaches.

The common scenarios proposed are based on the type of scenarios we understand to be considered in the financial markets. However, reflecting on consultation responses, we recognise that the stress tests may be too extreme so we have amended three of the scenarios to take account of views received in response to the consultation. We have reduced the totex underperformance scenario to 10% of totex, and reduced the impacts of the inflation scenario, and adjusted the scenario related to bad debt, reflecting suggestions that appear to be reasonable in consultation responses.

In order to enable us to draw out the additional insights we consider will be valuable by drawing comparisons and common themes across companies, each of the common scenarios should be modelled. Where companies consider that any of the scenarios (including the combined scenario) are not relevant or sufficiently challenging to their circumstances, we expect companies nonetheless still to model the scenarios and explain, with supporting evidence, their view about the relevance of the scenario and the basis on which financial resilience will be maintained. This may include mitigating actions the company has in place to prevent the scenario occurring and the planned management actions should the scenario arise. The key point is that, in all cases, companies should explain the basis on which financial resilience will be maintained.

We do not propose changing our guidance for the RoRE assessment, which applies to the notional financial structure. Assessment of financial resilience relates to actual financial structures, the scenarios we set out are intended to allow us to better understand how companies will address various downside scenarios in practice.

Assessing financial resilience in the IAP

It is the responsibility of the board of each company to ensure it is financially resilient and to provide a statement to that effect, demonstrating how the board has 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 PR19 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 3.

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 it has 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 Annual Performance Report and internal risk assessment).

Companies should model their own scenarios based on severe, reasonable and plausible scenarios for key variables to support their assessment, building on the long term viability statements that are included in Annual Performance Reports. Companies should also model a minimum suite of scenarios that are prescribed by Ofwat.

We also expect companies to:

- Provide evidence to support their risk assessment, to fully explain any company specific scenarios considered and why those scenarios are relevant. The assessment should demonstrate the impact of the scenarios on the company's financial position, and in particular its ability to comply with existing covenants and the ability to raise additional finance when required;
- Provide details of the assurance undertaken in relation to carrying out the assessment and to explain why the chosen level of assurance is appropriate;
- Clearly set out how they have determined their own scenarios (in addition to the common 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?

Each company should demonstrate how its actual capital structure is resilient for the long term, that it can maintain a robust investment-grade rating, and can support its obligations to customers in all foreseeable circumstances.

We expect each company to clearly demonstrate (i) that it has considered the range of measures available to secure the long term resilience of the company, and (ii) how 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 company's financial ring fence.

Where there is evidence that the financial resilience of the company might be at risk, business plans should provide evidence of any mitigating actions that the management and/or shareholders plan to take 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.

A1 Consultation respondents

Companies

Anglian Water
Welsh Water
Northumbrian Water
Severn Trent Water
South West
Southern Water
Thames Water
United Utilities Water
Wessex Water
Yorkshire Water

Affinity Water
Bristol Water
Portsmouth Water
South East Water
South Staffordshire Water
Sutton & East Surrey Water

Investor	Holding
iCON	Bristol
OMERS	Thames
Investors in Anglian Water Group	Anglian
Allianz	Affinity
BCI	Thames
Kelda	Yorkshire
Hermes	Thames
USS	Thames
Investors in Southern Water	Southern
Vantage Infrastructure	South East
Wren House Infrastructure	Thames

Other

Bristol Water Challenge panel
Water Plus
London Fire Brigade
CC Water
The Pensions Regulator

A2 Assessment of impacts

This section sets out our assessment of the impacts we expect as a result of our policy proposals over the five year PR19 period spanning 2020-25. We have chosen to focus on this period because the evolution of our price control framework at PR24 and beyond makes impacts beyond these years less certain.

We have focused most of our analytical effort on quantifying the financial impact we expect from our benefit sharing mechanism, as we consider this impact as potentially high value, and more suitable to quantify. We consider that our proposals will result in a range of other impacts which are important, but not suitable candidates for monetisation – we discuss these in the latter part of this section.

We assess three scenarios beginning at the start of the PR19 price control on 31 March 2020, concerning companies with March 2017 gearing over 70%[22]:

1. Deleveraging to 70% over 5 years plus benefits sharing;
2. Deleveraging to 70% over 10 years plus benefits sharing; and,
3. No deleveraging, just benefits sharing

We consider the outcome of our policy is likely to result in impacts which lie between Scenario 2 and 3, as:

- Scenario 2 is most representative of the proposals already put forward by some companies to reduce gearing levels through 2020-25.
- Scenario 3 is included to represent the possibility that shareholders may on balance decide that the residual incentives after our policy takes effect make retaining existing gearing levels the optimal response, as considered by one respondent to our consultation.

We estimate that the impact of our policy will result in a transfer of between £200 million and £230 million from investors to customers over the period 2020-25. These figures are equivalent to 0.3% of the expected RCV as at 31 March 2020 (£72.8

[22] These companies are: Affinity, Sutton & East Surrey, South East, Anglian, Southern, Thames, and Yorkshire

billion in 2017-18 prices and values[23]), or around 0.4% of expected turnover for the period 2015-20.

Table A2 – Financial impacts over 2020-21 – 2024-25 (£m, 2018/19 PV)

	Who will be affected?	Scenario 1: degearing to 70% over 5 years	Scenario 2: degearing to 70% over 10 years	Scenario 3: remaining at 2020 gearing
Sharing payments: A transfer from shareholders to customers if gearing exceeds 70%	Customers	170	200	230
	Shareholders	-170	-200	-230

To assess impacts, we derived March 2020 starting gearing levels for these companies by assuming that company net debt balances reported at March 2017 would increase through a combination of indexation of existing index-linked debt and financing all remaining additions to RCV for the 2015-20 PR14 control period with debt.

Our benefits sharing mechanism under these three scenarios compares our nominal PR19 final methodology early view cost of equity of 7.13% to the nominal cost of debt reported by companies as at 31 March 2017. We apply benefit sharing of 50% of the differential between these costs to all borrowing which contributes to gearing above our reference point, which is 65% of RCV. As a simplifying assumption, these calculations are based on each company's RCV continuing to grow during PR19 at the same rate as decided at PR14 final determinations. The results set out in table A2 are not very sensitive to this assumption however – assuming RCV growth of

[23] We have discounted to 2017-18 present values using the HMT Green Book recommended value of 3.5%

75% of its PR14 level would result in £10 million reduction to the largest impact on (scenario 3), with smaller decreases in customer benefits in the other two scenarios.

We consider below other potential sources of impact from our policy proposals. We have not monetised these impacts either due to uncertainty around their magnitude, or because we consider they do not arise as a consequence of our proposals:

- **Cost of equity** - We do not consider the proposals increase the cost of equity for the notional financial structure, as they are targeted at changes that impact only on those companies with gearing levels that are materially above the notional level (seven of the 17 companies we regulate reported gearing above 70% as at 31 March 2017). As the proposals apply to highly geared companies only, we consider there is no increase in systematic risk.[24] For these companies, in section 6.3.3 ('Economic and Corporate Finance Theory), we set out that one advantage of higher gearing to their shareholders lies in reducing value at risk. This is because, as gearing increases, the risks of financial failure are likely to increase and some risk maybe shifted onto customers and the taxpayer.
- **Cost of debt** - Where companies reduce gearing levels, it is possible that they will achieve higher credit ratings - and thus a lower cost of new debt in the future. This benefit could be captured for customers through enabling us to set a tougher efficiency benchmark for the cost of debt in future price reviews. However, our policy approach to the cost of debt at PR24 and beyond is not set, making any such estimate difficult to predict. We simply note that our estimate of benefits is likely to be conservative, as it does not capture any of the prospective benefits of this lower-cost debt.
- **Transaction costs** – Several consultation responses referenced additional costs of achieving rapid deleveraging profiles. We clarify that companies are not required to reduce gearing levels at all in response to our proposed benefit sharing mechanism. They may propose alternative mechanisms; and may in any case choose a different profile to that set out in our three scenarios as they see fit. The impact of the benefit sharing is limited to only those companies with gearing levels that exceed 70% (seven companies as at 31 March 2017). We note that these companies have considerable opportunity to take advantage of refinancing that they would have undertaken in any case during the 2020-25 period to adjust gearing. None of the

[24] Our framework for setting the cost of equity relies on the Capital Asset Pricing Model framework, under which only non company-specific, hard-to-diversify risks increase the required return.

consultation responses provided robust evidence as to the quantum of likely costs. We acknowledge that under scenarios 1 and 2, there may be some modest incremental costs borne by equity investors from refinancing arrangements, but we consider these costs are small in relation to benefits to customers.

- **Increased trust and confidence in the sector, enhanced legitimacy –** Several of our proposals aim to increase transparency and accountability to customers. Where customers perceive that their interests are appropriately aligned with those of shareholders, this supports the legitimacy of the regime, increasing investor confidence that it will persist and remain investable for the longer-term.[25] While quantifying this benefit is difficult, we consider it likely that it would exert downward pressure on the cost of capital, benefiting companies and customers.
- **Tax costs** - In theory our benefit sharing mechanism could result in higher customer bills due to companies reducing gearing and a corresponding increase in forecast taxable profit (which is reduced by debt interest). However, as set out in section 6.3.2, we do not consider this should be treated as a quantifiable benefit in an impact assessment as (i) it relates to a transfer between taxpayers and customers (which the Green Book advises should be excluded from estimates of social value[26]), and (ii) it relates to policy that was put in place by us precisely to disincentivise companies to increase gearing levels simply to receive a tax benefit. Even if this were treated as a benefit, we assess the benefit to be small and uncertain, lying in the range £0 million to £15 million, compared with overall impacts of £200 million to £230 million.
- **Administrative costs** – companies and Ofwat will incur some administrative costs associated with ensuring the requirements of our policy proposals are met in business plans, and are subsequently assessed in the IAP. For instance, we expect companies will need to review their draft business plans to ensure dividend and performance related executive pay policies are transparent and appropriate. We consider the administrative burden associated with (i) developing sharing mechanisms and (ii) the increased burden of our IAP assessment on companies to be low when considered against the scale of benefits.
- **Improved strategic focus -** Our proposals on executive pay, dividends, and benefit sharing aim to better align shareholder interests and management

[25] Morgan Stanley Research also make this point; see 'UK Regulated Utilities: Lower Return and Lower Risk', May 3 2018
[26] HM Treasury (2018), The Green Book, p40

incentives with customer priorities. Our targeted amendments to the PR19 methodology aim to increase management and shareholder focus by reference to issues that are valued by customers. It should also align management incentives with long-term shareholder interest, by strengthening incentives to act in ways that promote financial resilience, and which increase trust in the regulatory model.

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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