Putting the sector back in balance:

Consultation on proposals for PR19 business plans

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WONDERFUL ON TAP

SEVERN TRENT

Putting the sector back in balance – consultation on proposals for PR19 business plans

Executive summary

We recognise that, as a public utility, we operate in a privileged position. We provide water and wastewater services that are essential to the health and wellbeing of our customers and to wider society, including the environment. This requires us to continually work to exceed the expectations of our customers and the general public.

The consultation rightly recognises that concerns around the corporate behaviour of some companies has eroded trust, particularly among stakeholders. To rebuild this trust, the entire sector needs to respond positively to the worrying factors that caused the erosion in the first place. Therefore, we are very supportive of the underlying principles in Ofwat's consultation. We consider that many of the proposals build on the PR19 methodology and, as such, will enhance the legitimacy of the sector.

For the sector to thrive, it is critical to have a balanced approach, which means all parties share in success. Accordingly, our response focusses on how best to correct that balance across the four key topics: high gearing; dividend policy; executive remuneration; and financial resilience. We discuss a number of important points, which we consider are necessary to deliver the best outcome for all stakeholders, in the form of a series of recommendations.

High gearing

As early as 2012, we highlighted the need for a sustainable approach to financing[1], where we advocated options that would deliver a more sustainable level of gearing and provide suitable rewards and incentives to retain and attract equity in the sector. We are therefore supportive of the proposal to require companies that are highly-geared to share the associated benefits with customers, subject to addressing certain points of detail. There are of course other options that could be considered, but we believe this is a pragmatic approach.

Naturally, care needs taking with the design and implementation of this policy, as it could have perverse implications. For example, overly tight restrictions on gearing could see companies having to seek additional (expensive) equity to provide funding for variations arising from the investment profile. As the consultation recognises, gearing will fluctuate throughout a price control period depending on the investment profile of the company, and whether Ofwat's debt and inflation assumptions are consistent with actuals. We therefore believe that this policy needs to be accompanied by the following:

- *Recommendation 1 – the trigger in relation to gearing should reflect an average of 67.5% over the AMP. This is important because it allows a company geared at the notional level at the start of the AMP the flexibility to carry out a planned capital programme over the AMP that increases gearing above the notional level for a short period of time; and*
- *Recommendation 2 – gearing should be based on the Ofwat definitions of gearing (excluding pension deficits) and debt.*

In order to address unduly high gearing, we believe it is important to ensure strong incentives remain for equity, alongside steps to discourage over gearing. Not only would this help create a 'stick and carrot' approach to debt, but also help address inherent biases, such as the tax regime, that favour debt over equity.

As Ofwat notes, water companies are seen by investors as income stocks, and investors have a demand for a reasonable dividend predictability and stability. While we believe that customers should not bear the costs of risky financial structures through increases in their bills – due to the need to use financial levers – those

[1] Severn Trent and National Grid (2012), "*Changing course through sustainable financing – options to encourage equity financing in the water and energy sectors.*"

companies with a solid track-record on financeability should have greater flexibility for using financeability levers responsibly. Hence we have a further recommendation relating to gearing:

- *Recommendation 3 – companies that have a track record of sustainable gearing could be allowed greater flexibility to use financeability levers, subject to wider considerations, such as improving overall affordability.*

In relation to embedded debt, we believe that prescriptive rules on sharing should not be imposed given the strong incentives that exist to minimise costs, which ultimately passes savings on to customers. As we understand it, the rationale for raising the possibility of a sharing type mechanism is not because of the low cost of embedded debt, but rather how companies share outperformance more broadly, which we address separately.

Dividend policy

We are firmly of the view that trust and confidence in the sector can be enhanced by transparency over how dividends relate to the delivery of service to customers.

As a listed company, we are keenly aware of the need for transparent dividend policies, which are important to public shareholders. Amongst other things, it is the evidence of the management's quality and its ability to legitimately outperform, operationally. We believe that our current performance and approach relating to dividends does not undermine trust in Severn Trent. We have maintained gearing at the notional level, paid a base dividend consistent with the cost of capital, shared outperformance with all stakeholders and not used shareholder loans or other forms of financial engineering to inflate returns. However, we recognise the challenges facing the sector and the need to evolve in ways that seek to enhance the legitimacy of the sector.

We support the underlying principle of the proposals set out in the consultation paper. So, where dividends arise purely from excessive gearing along with financial engineering activities such as securitisation (with its attendant loss of management flexibility and control), the dividend policy should reflect an even sharing of risk between customer and investor.

In relation to pay-out ratios, we believe it is helpful for Ofwat to recognise the fact that water utilities are considered income stocks by investors – and the consultation paper discusses a nominal base dividend yield of 5%. Ultimately, dividend yields are the combined result of share price performance and company performance. As Ofwat's analysis of FTSE 100 dividend yields shows, there can be periods of market volatility whereby increased dividend yields are the result of falling share prices, rather than improved profitability.

The assumption on an appropriate dividend yield is critical – and if this assumption is set too low, balance sheets could under certain circumstances become inefficient – with too little gearing. In addition, as we in all likelihood move towards a future with higher inflation and increasing bond yields, we will likely see an unwinding of previous trends, with the dividend yields from income stocks returning to higher levels. As such equity investors could become dissatisfied with the income portion of their return if this is set too low. Accordingly, we have the following recommendation:

- *Recommendation 4 – given the income nature of water stocks we suggest an assumption of a nominal base dividend yield of 5% is appropriate – on the basis of delivering reasonable base dividends.*

Companies should publish principles that behaviours must conform to in relation to dividend policy[2]. At the same time, the requirement for these principles should ensure the companies have sufficient discretion and so avoid indicating to the market that they do not have sufficient dividend flexibility.

We believe, however, that the initial assessment of business plans (IAP) tests should differentiate between those companies that have a proven track record and those that do not. Consistency is important given the long-term financing requirements for the sector. Ultimately, the track record of a company's dividend policy is a critical feature, because this is what customers and society can observe and this is how we are judged. We

[2] Listed companies cannot specify the exact dividend policy, as this could be interpreted as a profit forecast.

therefore consider that a further refinement to the proposals can provide an even sharper incentive to build and maintain a strong track record:

- *Recommendation 5 – the principles on dividends should also cover a company's track record on dividend policy, including the use of shareholder loans. Companies that can demonstrate a strong track record should be allowed to retain a higher degree of flexibility.*

On the base dividend, it is not clear whether additional rules are needed to govern its distribution. With the new gearing mechanism, there is an even stronger incentive to manage dividends so that target gearing levels are met. For example, we see that some companies may need to partly or wholly withhold dividends in order to achieve the desired gearing levels within an acceptable timeframe.

The overall dividend paid out by a company like Severn Trent Plc will be a function of: the base level dividend from Severn Trent Water; outperformance in the regulated business (increasingly from ODIs and, in time, greater competition); and performance from our non-regulated business. Therefore, in the absence of excessive gearing, the ability to make dividend payments from the regulated business should genuinely reflect over or under-performance. With this in mind, we further recommend:

- *Recommendation 6 – the dividend yield of 5% is measured in relation to base dividends only arising from the regulated business, such that dividends arising from outperformance and the non-regulated business are treated and assessed separately.*

We recognise that proposals relating to dividends are a sensitive issue amongst the investment community. Accordingly, we intend to engage brokers on the development of our PR19 plans, to ensure we have equity-holder support.

In relation to sharing outperformance, we believe that this should not be done through a formal mechanism. In this AMP we have already shared the outperformance from greater totex efficiency by reinvesting £120m in the business and will be looking to share future efficiencies in a similar way. A company's track record, we believe, is critical in this area, and we have a further recommendation:

- *Recommendation 7 – companies should set out in their business plans their proposals for sharing the benefits of outperformance, with Ofwat placing the emphasis on a company's track record.*

Executive remuneration

We firmly believe that customers and wider stakeholders must have confidence in the companies' executive remuneration policies. In light of growing public frustration with opaque corporate structures and offshore holdings, we think companies should be fully disclosing the remuneration of executives from both the regulated company <u>and</u> any related parties. Far greater transparency is critical.

We also strongly believe that executive remuneration needs to be geared towards delivering long-term benefits to customers. The bonus components of executive pay could focus on:

- activities that drive good outcomes for customers and the environment, including long-term asset health;
- delivering upper quartile performance in terms of Ofwat's definition of RoRE, which is the most comprehensive comparative measure; and
- ensuring long-term performance through the use of holding periods in relation to share options, whereby the share price at the end of the holding period – rather than at the point of grant – determines the value of the remuneration.

Companies could be expected to set this out in their business plans, along with their track record in this regard. As such we recommend the following:

- *Recommendation 8 – company Boards should explain how the remuneration policy is consistent with delivering benefits to customers over the short and long term.*

At Severn Trent, the Board is accountable for remuneration policy in line with good corporate governance. Our remuneration policy is subject to a shareholder vote every three years and the Board, via the Remuneration Committee, scrutinises performance on a quarterly basis. Our Corporate Responsibility

Committee has also requested that both reputation and customer perceptions become part of the in-the-round decision-making process.

Financial resilience

We believe having a robust, transparent process for reviewing financial resilience on a regular basis is important in building trust and confidence in the sector. As Severn Trent is a material part of a listed group, we are required to perform an annual review of our financial resilience and viability which is published in our group annual report and accounts. This involves stress-testing our forward looking plans by modelling a number of plausible and severe scenarios (including combined scenarios) which reflect the risks to the business. We have used the scenarios proposed in the consultation paper as part of our financial viability statement testing for the 2017/18 financial year, along with further scenarios developed from the principal risks included in our Enterprise Risk Management (ERM) system.

We welcome the clarity provided on Ofwat's views on financial resilience, and agree that the assessments outlined should be applied consistently across all companies in the sector. Care of course needs to be taken to make sure such tests are not overly prescriptive or too extensive, otherwise there is a danger that this becomes an elaborate and mechanical exercise rather than one of seeking to understand the financial resilience of a company.

We note the expectation to explain the impact of the stress tests on a company's ability to maintain financial metrics and their credit rating. We agree that, in light of the requirement to maintain an investment grade rating, companies should clearly set out the mitigating actions they would take to restore their rating to investment grade for those scenarios that put the company at risk of falling below that threshold.

We consider that there should be two small amendments to the proposals to ensure that the interventions are targeted and proportionate:

- *Recommendation 9 – we agree that companies should clearly set out the mitigating actions they would take to restore their rating to investment grade, for those scenarios that put the company at risk of falling below that threshold. However, where scenarios may only create a risk of a reduction in credit ratings, which itself is uncertain because at higher thresholds agencies assess other factors, we do not consider this necessitates an explanation of the impact; and*
- *Recommendation 10 – companies should engage with customers if a financial resilience 'event' occurred and we were considering mitigation options that could adversely affect customers. However, companies should not be required to engage with customers on financial resilience assessments or potential mitigating actions, for instance drawing on committed credit lines, seeking waivers on covenants or injecting more equity. Such engagement would not add value to our potential response but, instead, could be easily misconstrued.*

Conclusion

We are supportive of the direction of travel laid out in the consultation paper as a means of restoring greater trust and confidence in the water sector. As with all significant developments in the regulatory framework it is important, however, to ensure that the design of the specific mechanisms are robust and suitably balanced to provide the right incentives for the sector.

Of the ten recommendations we have set out above, we believe the following four recommendations are fundamental to ensuring this balance – and therefore critical in our support of the proposals set out by Ofwat:

- High gearing:
    - *Recommendation 1 – the trigger in relation to gearing should reflect an average of 67.5% over the AMP;*
    - *Recommendation 2 – gearing should be based on the Ofwat definitions of gearing (excluding pension deficit) and debt;*
- Dividend policy:
    - *Recommendation 4 – given the income nature of water stocks we suggest an assumption of a nominal base dividend yield of 5% is appropriate – on the basis of delivering reasonable base dividends; and*

- *Recommendation 6 – the dividend yield of 5% is measured in relation to base dividends only arising from the regulated business, such that dividends arising from outperformance and the non-regulated business are treated and assessed separately.*

We have also discussed above, on a number of occasions, that there should be much greater emphasis on a company's track-record of exhibiting the right behaviours. This is ultimately what matters because it is how customers and stakeholders judge the sector. Such an approach would significantly increase the power of principle-based regulation, because it puts the onus on companies to both consider what amounts to appropriate behaviour and deliver on that, rather than Ofwat having to set detailed and prescriptive rules.

We therefore consider that the IAP should also include a mandatory requirement for fast tracked and exceptional companies to have demonstrated a track-record against each of the four key pillars. This would also mitigate the risk that a fast track or exceptional company could subsequently be found to have issues that cut to the core of the public's concerns, such as hidden payments from related parties. We therefore propose a further recommendation:

- *Recommendation 11 – we believe fast-tracked and exceptional companies need to have demonstrated a track-record against the four pillars, namely gearing, dividend policy, executive remuneration and financial resilience.*

In the table below, we discuss our sustained long-term performance against the four pillars.

We also note that our Board, which has a majority of independent non-executive directors, provides assurance across each of these elements, through our Treasury Committee, Remuneration Committee, Audit Committee and the full Board. The views of institutional shareholder proxy advisors and the investor confidence shown by the voting records both provide additional assurance that we are taking significant steps in rebuilding trust and confidence in the sector.

Table 1 – Severn Trent case study: sustained long-term performance

Four pillars	Evidence
Gearing	• **Geared at the notional level for almost 20 years**, with no financial engineering or shareholder loans used to generate extra returns • All outperformance driven by genuine improvements in either service or efficiency • Responsible use of financial levers – 5% real RPI-based reduction in bills at PR14 despite substantial investment programme
Dividend policy	• Gearing kept stable with a sustainable, resilient financial structure maintained • All parties benefit from our outperformance. **Over the first three years of this AMP**: – generated savings that will result in £120 million being shared with customers – reinvested £220 million of totex outperformance – £90 million extra investment in pension scheme – multi-million pound investment in all company employee bonus scheme – increased base dividend by 4% achieved without impact on gearing
Executive remuneration	• Executive salaries and awards all published and aligned to regulatory measures • Bonus scheme – linked to a combination of customer-driven and financial measures to support payment. Not delivered via debt/gearing • Long-term incentive plans set with reference to RoRE, which includes totex and ODI • Annual shareholder vote on executive remuneration • Corporate Responsibility Committee has requested that both reputation and customer perceptions become part of the in-the-round decision-making process
Financial resilience	• Stress scenarios tested **this year**: – stress testing our forward looking plans – modelling plausible and severe scenarios (including combined scenarios) to reflect business risks – scenarios drawn from the principal risks included in our Enterprise Risk Management (ERM) system – used the scenarios proposed in Ofwat's consultation paper as part of our financial viability statement testing for the 2017/18 financial year, along with further scenarios developed from the principal risks included in our Enterprise Risk Management (ERM) system.

Summary of consultation questions and responses

1) *Do you agree that companies should be* ***required to propose mechanisms for sharing financing outperformanc****e in their business plans, and that we should assess such mechanisms in the IAP?*
2) *Where adequate mechanisms are not offered in business plans, do you agree we should* ***intervene to impose a sharing mechanism****, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?*
3) *Do you have views on our proposals for the* ***design of the outperformance sharing mechanism for highly geared structures****? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?*

We are supportive of Ofwat's emphasis on sustainable gearing and its proposal to require highly-geared companies to share the associated benefits with customers, subject to addressing certain points of detail. We propose that the trigger in relation to gearing should reflect an average of 67.5% over the AMP and that gearing should be based on the Ofwat definition of gearing (excluding pension deficits) and debt.

We also see there are additional worthwhile refinements. These include seeking to strengthen incentives for equity and allowing greater flexibility to use financeability levers for those companies with a track record of sustainable gearing. One potential change would be for the pay as you go (PAYG) tools to support responsible cash-flow phasing, provided they can demonstrate to Ofwat that they are improving overall affordability.

We support Ofwat's decision not to intervene and impose prescriptive rules on embedded debt given that the current approach already passes the savings to customers. We also note that our current cost of embedded debt is broadly equal to the cost of debt proposed at PR19. In our view, the use of a mandated mechanism at PR19 would not offer material value to our customers, but would further complicate an already robust and challenging regulatory regime. We believe the most effective approach is to encourage companies to share outperformance more broadly. As a responsible company, this is something we have done and will continue to do – through reinvestment, additional support for vulnerable customers, our staff bonuses and increasing investment to close the pension deficit.

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

We recognise the challenges facing the sector and the need to evolve in ways that seek to enhance the legitimacy of the sector. We are supportive of the need for companies to have a balanced approach to sharing performance benefits. We therefore agree with the principle of the proposal and would add that the details warrant further consideration both to ensure consistency for listed companies and to distinguish those companies with solid past performance.

As a listed company, we are keenly aware of the need for transparent dividend policies, which are important to public shareholders. Amongst other things, it is the evidence of the management's quality and its ability to legitimately outperform, operationally. However, we recognise the challenges facing the sector and the need to evolve and enhance the legitimacy of the sector. So, where dividends arise purely from excessive gearing along with financial engineering activities such as securitisation (with its attendant loss of management flexibility and control), the dividend policy should reflect an even sharing of risk between customer and investor.

We think it is important that the proposal, other than specifying principles, do not extend to an intervention on how the dividend policy is set. Listed companies cannot specify the exact dividend policy, as this could be interpreted as a profit forecast. This means we cannot specify the exact policy in our submission but rather provide Board-assured principles that govern our behaviour.

In relation to pay-out ratios, we believe it is helpful for Ofwat to recognise the fact that water utilities are considered income stocks by investors – and the consultation paper discusses assuming a nominal base dividend yield of 5%. Given the income nature of water stocks we suggest that this yield of 5% is appropriate – on the basis of delivering reasonable base dividends. Ultimately, dividend yields are the combined result of share price performance and company performance. As Ofwat's analysis of FTSE 100 dividend yields shows, there can be periods of market volatility whereby increased dividend yields are the result of falling share prices, rather than improved profitability.

The assumption on an appropriate dividend yield is critical – if this assumption is set too low, balance sheets could, under certain circumstances, become inefficient – with too little gearing. In addition as we in all likelihood move towards a future with higher inflation and increasing bond yields, we will likely see an unwinding of previous trends, with dividend yields from income stocks returning to higher levels. As such, equity investors could become dissatisfied with the income portion of their return if this is set too low.

We consider, however, that the proposal should distinguish companies with a solid track record, because it is what customers and the wider public see and it is how we are judged. As such, the level of prescription in the principles should depend on the dividend policy track record, including the use of shareholder loans. In practice, companies demonstrating strong behaviours would retain a higher degree of flexibility.

On the base dividend, it is not clear whether additional rules are needed to govern its distribution. With the new gearing mechanism, there is an even stronger incentive to manage dividends so that target gearing levels are met. For example, we see that some companies may need to partly or wholly withhold dividends in order to achieve the desired gearing levels within an acceptable timeframe.

We also think the articulation of a distribution policy needs considering in the context of the regulated business versus the holding company. In our case, we generate profits outside of the regulated business and this distinction needs to be clear, such that dividends arising from outperformance and the non-regulated business are treated and assessed separately.

The overall dividend paid out by a company like Severn Trent Plc will be a function of: the base level dividend from Severn Trent Water; outperformance in the regulated business (increasingly from ODIs and, in time, greater competition); and performance from our non-regulated business. Therefore, in the absence of excessive gearing, the ability to make dividend payments from the regulated business should genuinely reflect over or under-performance.

We recognise that proposals relating to dividends are a sensitive issue amongst the investment community. Accordingly, we intend to engage brokers on the development of our PR19 plans, to ensure we have equity-holder support.

In relation to sharing outperformance, we believe that this should not be done through a formal mechanism. In this AMP, we have already shared the outperformance from greater efficiency by reinvesting £120m in the business and will be looking to share future efficiencies in a similar way. A company's track record, we believe, is critical in this area. So, companies should set out in their business plans their proposals for sharing the benefits of outperformance, with Ofwat placing the emphasis on a company's track record.

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

We firmly believe that customers and wider stakeholders must have confidence in the companies' executive remuneration policies. In light of growing public frustration with opaque corporate structures and offshore holdings, we think companies should be fully disclosing the remuneration of executives from both the regulated company <u>and</u> any related parties. Far greater transparency is critical.

We also strongly believe that executive remuneration needs to be geared towards delivering long-term benefits to customers. The bonus components of executive pay could focus on:

- activities that drive good outcomes for customers and the environment, including long-term asset health;
- delivering upper quartile performance in terms of Ofwat's definition of RoRE, which is the most comprehensive comparative measure; and
- ensuring long-term performance through the use of holding periods in relation to share options, whereby the share price at the end of the holding period – rather than at the point of grant – determines the value of the remuneration.

At Severn Trent, the Board is accountable for remuneration policy in line with good corporate governance. Our remuneration policy is subject to a shareholder vote every three years and the Board, via the

Remuneration Committee, scrutinise performance on a quarterly basis. Our Corporate Responsibility Committee has also requested that both reputation and customer perceptions become part of the in-the-round decision-making process.

We believe that Ofwat should be careful to avoid evaluating executive remuneration in isolation. In its IAP, we believe Ofwat should be using the four pillars (ie, gearing, dividend policy, executive remuneration and financial resilience) particularly in relation to a company's track record.

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

We are supportive of expanding the IAP test to include trust covering the four pillars described above. In addition, we think greater prescription would be helpful and, as noted above, believe that the IAP should explicitly consider:

- transparency on executive pay arising from both the regulated company <u>and</u> related parties; and
- an assessment of the company's track record on sharing benefits, as well as its forward-looking promises.

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

We believe a robust, transparent process for regularly reviewing financial resilience is important in building trust and confidence. We welcome the clarity provided on Ofwat's views on financial resilience, and agree that the assessments outlined should be applied consistently across all companies in the sector. We also believe, however, that the number of scenarios to be modelled should be limited, in order to focus on the critical factors relating to financial resilience.

We note the expectation to explain the impact of the stress tests on a company's ability to maintain financial metrics and their credit rating. We agree that, in light of the requirement to maintain an investment grade rating, companies should clearly set out the mitigating actions they would take to restore their rating to investment grade for those scenarios that put the company at risk of falling below the threshold.

We recommend two small amendments to ensure targeted and proportionate interventions:

- where scenarios may only create a risk of a reduction in credit ratings – which itself is uncertain because, at higher thresholds, agencies assess other factors – we do not consider this necessitates an explanation of the impact; and
- companies should not be required to engage with customers on financial resilience assessments or potential mitigating actions, such as drawing on committed credit lines, seeking waivers on covenants or injecting more equity. Such engagement would not add value to our potential response but, instead, could be easily misconstrued.