Putting the sector back in balance

United Utilities' response to consultation on proposals for PR19 business plans

Introduction

Thank you for the opportunity to comment on Ofwat's proposals to make targeted amendments to, and clarifications of, the methodology for the PR19 price setting process following the 13 April 2018 implementation letter to Chief Executives.

United Utilities is a publicly listed, responsibly financed company with one of the lowest rates of gearing in the sector. We hold ourselves to the highest standards of corporate governance as embodied in the Financial Conduct Authority's Listing Rules, the Disclosure Guidance and Transparency Rules and the Financial Reporting Council's UK Corporate Governance Code. Since 2015, UUG's Annual Report has been an Integrated Report in accordance with the International <IR> Framework and has won cross sector awards, including being a joint winner for "Excellence in reporting" at the 2015 Building Public Trust Awards sponsored by PWC. Our 2016 Annual Report won the 'Communicating Integrated Thinking' award at the Finance for Future Awards sponsored by Deloitte, ICAEW and A4S. We were also the first water company – and one of the first FTSE100 companies – to publish a Long-term Viability Statement in 2015. In 2016, we were also one of the first to publish tax policies and objectives and to apply FR Lab guidance on best practice disclosure on dividends.

In AMP5 we voluntarily shared c£250m of outperformance benefits with customers through reinvestment in their services. In AMP6 we have so far committed to further reinvestment of £100m. [✂ …. .✂]

Through these actions we have sought to balance the sharing of benefits between customers and investors when the company has outperformed the regulatory contract. Outperformance has not been based on the utilisation of aggressive financing arrangements. Executive pay for performance has strong, direct links to the successful delivery of services to customers through, for example, ODI performance, customer service performance through Ofwat's SIM measure and through delivery of capital programmes to time, cost and quality.

Research undertaken in the North West shows that UU scores well on characteristics such as social responsibility, trustworthiness, reputation and innovation amongst the population we serve. However, the sector as a whole has a responsibility to step up and respond to the legitimacy challenges it faces and UU must play its part in supporting this. This is vital to building trust and confidence of customers and other stakeholders. Without this, further regulatory intervention and enforcement may become inevitable, with its own separate risks of tilting the balance in the opposite direction and undermining trust and confidence of the capital markets on whose ongoing support the sector depends to remain viable businesses, investing in a vital public service.

Putting the sector back in balance – UU response

Ten point summary view

Our summary view is as follows:

1. **We support the principle that where companies have chosen to adopt highly geared structures, the financial benefits that flow from this should be shared with customers**. This is justified because whilst highly geared structures allow the extraction of additional income for investors, they offer little obvious direct benefit to customers and arguably reduce financial and operational resilience to sudden shocks. Sharing the financial benefits that flow from highly geared structures provides customers with at least partial compensation for these negative effects.

2. **We support the high level approach to sharing financial benefits of high gearing presented by Ofwat in its consultation.** We consider that intervention by Ofwat is justified where companies themselves do not act to propose a suitably transparent approach in their business plans. These proposals should be applied in the context of a company's overall financing position. In particular, it is important that measures which Ofwat intends only to apply to highly leveraged structures do not unintentionally impact companies with a more responsible and sustainable financing structure.

3. **The calculation of gearing in this context should recognise that pension deficits are a form of debt.** Responsibly financed companies will recognise pension deficits as a long-term liability that ultimately must be settled. Reflecting the IFRS valuation of the company pension deficit as part of the gearing assessment would provide a first-line check that customers' long term interests are being protected. This is because it gives visible assurance that – when making decisions about gearing – companies must also give consideration to the existence of future funding obligations to meet commitments made to employees. It would also be consistent with rating agencies' assessments of gearing. Normalising these deficits would provide an even more robust assessment.

   If pension deficits are not recognised as part of the gearing estimate then companies are less incentivised to pay down pension deficits, in favour of reducing other forms of debt. Indeed, companies could be incentivised to allow pension deficits to increase where funds can instead be diverted to reduce the reported gearing position.

4. **When defining a "highly geared" company, the "gearing difference" buffer should be set at a reasonable margin above the 60% assumption for the notional company.** This allows scope for companies to manage short term fluctuations in gearing. Moody's current guidance is that gearing could be as high as 74% and still be consistent with a Baa1 investment grade credit rating. An A3 rating, one notch above investment grade, requires gearing of less than 68%. Even at 60% gearing, variations of 2-3% due to the phasing of capital investment and 2-3% due to fair value adjustments for debt and derivative instruments are possible. **We therefore consider that the incentives for sharing the benefits of high gearing should apply to companies once they reach 68% gearing.** Consistent with Moody's definition, this threshold should include the IFRS valuation of pension deficits where applicable.

5. **It is important that companies are incentivised to use the "gearing difference" buffer to responsibly manage fluctuations in gearing, not to use it as a de facto softer benchmark for notional gearing. Accordingly, sharing financial benefits of high gearing should not be restricted to that element of gearing that exceeds the "gearing difference" threshold.** A company is only likely to reach 68% of gearing as a result of conscious decisions to gear at this level – it is unlikely to be so far from the notional level of gearing by accident. We therefore consider that it would be reasonable, once a company reaches 68% gearing, to require that it shares the financial benefits of all gearing in excess of the 60% notional gearing assumption.

6. **Ofwat's IAP process should provide positive recognition where companies have an established track record in taking a long term, responsible approach to financing.** Not all companies in the sector have taken advantage of the opportunity to gear up in pursuit of the financial benefits of high leverage. They have not contributed to the reduction in financial resilience or the loss of trust and confidence in the sector that Ofwat identifies. Their position at the end of AMP6 means they are likely to set the high standards for the sector in AMP7. Ofwat should consider how it can actively recognise these companies' track record as part of its Initial Assessment of Plans at PR19. This would demonstrate that responsible financing choices made by companies are capable of being rewarded. It would also be a justified reward for companies that have eschewed the financial benefits associated with high gearing, in favour of financial structures which offer customers more resilience and more trust and confidence in AMP6 and AMP7.

7. **Incentives should apply on an annual basis, from the beginning of AMP7.** We expect that Ofwat will be petitioned to provide more time for companies to adjust or for it to measure gearing on a five year – rather than annual – basis. We do not believe that such requests are in the best interests of customers as they would:

   - blunt incentives to act quickly to reduce excessive gearing;
   - extend further the period in which regulation fails to differentiate between companies based on the degree of responsibility in their financial structures; and,
   - reduce the effectiveness of Ofwat's proposed measures in building near term trust and confidence in the sector.

   The current situation requires that action is prompt, not subject to delays. The proposed approach does not appear to ask highly geared companies for the impossible. Beyond demonstrating that their business is financeable under the standard notional company structure, they are being asked to make available <u>partial sharing</u> of <u>additional financial benefits</u> that they obtain through their decision to maintain gearing beyond the notional assumptions.

8. **Beyond sharing financial benefits associated with high levels of gearing, further benefit sharing with customers should not be overly focussed on financing outperformance: it should take account of all sources of outperformance in the round.** In our AMP7 plan we expect to propose benefit sharing arrangements which are calibrated to the company's overall performance as measured by the Return on Regulated Equity (RORE.) These will reflect a consolidated picture of all areas of outperformance against the regulatory contract, not merely financial outperformance. This ensures that customers can benefit from the widest possible range of potential outperformance and that incentives for efficient Treasury management to outperform on the cost of debt are not diminished. Such incentives are important drivers of lower financing costs in the sector in the long term.

9. **We support Ofwat's proposal for additional transparency about company dividend policies. We consider that these should have a clear link to policies on the sharing of outperformance with customers. This is part of ensuring that a fair balance is struck between returns to investors and benefits for customers and the environment.** Dividend policy is a matter reserved for the Board and can only be set with knowledge of the final determination. Further, the declaring and payment of dividends can only be appropriately undertaken in view of the company's actual financial performance and the broader circumstances that prevail at the time. However, subject to those important considerations, we are able to make a number of observations about how we may approach these issues in AMP7. Dividend policies should take account of the allowed returns to equity and the assumed level of gearing in the determination of price limits.

<u>Interaction between base dividend payments and gearing:</u>

- Where a company's actual gearing is within a range between 60% and 68% gearing, then a responsible base dividend policy would balance distributions to shareholders with the retention of profits within the business to manage resilience. We note Ofwat's analysis that a base dividend in excess of 5% of the equity proportion of the RCV would need to be carefully justified for AMP7.
- Where a company's actual gearing is – or is forecast to be – substantially in excess of the notional assumption (for example, 68% or more including consideration of pension liabilities) then dividend retentions should be considered as a potential means of restoring gearing to more normalised levels.
- Where a company's actual gearing is below the notional gearing assumption, then it should be able to make additional dividend distributions to shareholders up to and including the full nominal allowed cost of equity (7.13% assumed for AMP7) or the full amount of profit after tax – whichever is greater - in order to take steps to optimise its capital structure closer to the notional level of gearing (60%.) Recognising this point is important for three reasons.

  i. Firstly, it reduces the risk that shareholders in companies that have supported responsible financing structures are penalised as a result of modest levels of gearing.
  ii. Secondly, it provides clarity that companies are free to seek efficient capital structures where these do not require levels of gearing above the notionally assumed level.
  iii. Third, it ensures that in future companies are not disincentivised from retaining profits where they might prudently do so, for fear that such funds becomes irretrievable in the long term.

<u>Interaction between dividend payments and the sharing of outperformance:</u>

- In addition to the potential for voluntary sharing of outperformance with customers (as has been the case for UUW in AMP5 and AMP6) we consider it could be appropriate to pre-commit to a guaranteed sharing of outperformance with customers where the company's RORE exceeds a certain threshold above the base level assumed in the business plan. Outperformance up to that level could be paid as a dividend to shareholders subject to consideration of financial resilience, any pension deficit and forecast gearing,
- If a company wishes to pay an outperformance dividend to shareholders above this RORE threshold then there would be matched sharing of these payments with customers through – for example – reductions in customer bills or investment outside the RCV.
- If a company earns outperformance and chooses to forgo the extraction of this outperformance via an enhanced dividend – for example by choosing to reinvest outperformance in the business to drive future improvements for customers and/or the environment – then reinvestment through the standard regulatory RCV mechanism is appropriate. This is consistent with the broader regulatory incentive framework for outperformance incentives and strikes an appropriate balance between shareholders and customers in building future service resilience.

This approach to a policy which triangulates gearing, dividends and the sharing of outperformance is summarised in table 1 below. In all cases, stakeholders would be consulted about the application of funds released through outperformance sharing in order to ensure that they were being used in a way that best reflects customer, societal and environmental priorities.

Putting the sector back in balance – UU response

Table 1: Summary of triangulation between gearing, dividends, outperformance and reinvestment

	Gearing <=60%*	Gearing >60%, <68%*	Gearing =>68%*
Base dividend to shareholders	Up to the greater of 100% of PAT or 100% of nominal allowed equity returns embedded in final determination (7.19% assumed for AMP7)	Up to 70% of nominal allowed equity returns – this equals 5% for AMP7	Dividend payments restricted in order to help return gearing to more normalised levels
Outperformance dividend paid to shareholders up to predefined threshold of RORE outperformance**	Outperformance dividends distributable to shareholders subject to explicit assessment of financial resilience, pension deficit and forecast gearing position.		Outperformance retained in order to return gearing to more normalised levels
Outperformance dividend paid to shareholders beyond predefined threshold of RORE outperformance***	Outperformance dividends distributable to shareholders subject to explicit assessment of financial resilience, pension deficit and forecast gearing position Guaranteed matched benefit sharing with customers (eg: bill discounts, investment outside the RCV)		Outperformance retained in order to return gearing to more normalised levels
Outperformance retained in company for improvements in service, resilience or the environment	Retained through standard regulatory mechanisms (eg: investment through Totex menu)		

* Net of IFRS measurement of pension deficit

**The payment of any outperformance dividend would be subject to the company not being in material breach of its statutory obligations.

***The payment of outperformance dividends beyond the predefined RORE threshold would be subject to the company materially meeting its AMP7 performance targets or be alongside committed reinvestment in order to meet these targets.

10. **We support Ofwat's proposals on greater transparency on how executive pay aligns to the delivery of service to customers and its proposed common scenarios for resilience**. We will provide additional coverage of both these areas in our PR19 submission. Building further on our existing arrangements for executive pay, the company's remuneration committee will be undertaking a full review of how performance based pay to be applied from 2020 onwards is linked to service delivery for customers and we will provide further information on the scope of this review in our business plan submission.

Our comments on Ofwat's specific questions are set out on the following pages.

Putting the sector back in balance – UU response

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

We agree that it is appropriate to require companies to propose mechanisms for sharing outperformance in their business plans and that Ofwat should assess such mechanisms in the IAP.

We also welcome Ofwat's clarity that its proposals <u>to require</u> benefit sharing are specific to those companies with gearing above the notional level. This is appropriate as although investors in such companies take the risk/reward benefit of high leverage, the residual risk profile for customers from extreme risks associated with company failure is significantly increased and it is therefore right that customers should receive a share of the outperformance from such structures. Limiting the requirement for benefit sharing to these circumstances contributes significantly towards demonstrating that the benefit sharing proposals are proportionate, targeted, transparent and accountable and consistent with the long term aims of facilitating trust and confidence in the water sector in England and Wales.

As a company with one of the lowest levels of gearing in the sector and with no expectation of becoming a highly geared company in AMP7, United Utilities recognises that Ofwat's proposals on benefit sharing target behavioural change elsewhere in the sector.[1] It is important to ensure that proposals which are targeted at highly leveraged structures do not unintentionally impact companies with a more responsible and sustainable financing structure.

However, given the broader context of building legitimacy for the sector as a whole, we believe that some consideration of our own approach to sharing of outperformance is pertinent.

United Utilities has a strong track record in sharing outperformance with customers. In AMP5 this included over c£250m of reinvestment in services and a discount to customer bills in 2014/15. In AMP6 we have so far committed to further reinvestment of £100m. [✂ …. ✂] In addition between 2015/16 and 2019/20 we expect to have made over £50m of shareholder contributions to provide financial support to customers.

This sharing of outperformance with customers was made voluntarily, on an ex-post basis. Our aim has been to jointly improve services to customers and ensure they share the benefits of outperformance along with investors.

For PR19 the methodology has always been clear that, in addition to the possibility of ex-post benefit sharing, a high quality business plan would include an ex-ante mechanism to pre-commit to sharing outperformance with customers. We have been considering a number of alternative options in this regard and expect to propose such a mechanism in our own business plan.

This will be in addition to a number of new mechanisms introduced by Ofwat that are expected to automatically increase the sharing of outperformance with customers. These include the debt indexation mechanism, the revised approach to corporation tax changes and capital allowance rates and delivering asymmetric cost sharing rates for company expenditure.

Where companies are not exposing themselves or customers to the risks of high levels of gearing, we consider that the best approach to sharing outperformance is to consider it across the full range of activities covered in the regulatory contract, rather than overly focus on financial outperformance.

Whilst it is clearly necessary to reign in the excesses of high leverage, it is important to ensure that elsewhere in the sector companies retain incentives for a strong effort by management and Treasury teams to outperform other notional financing assumptions wherever possible. This is because it is those efforts that will continue to drive financing costs lower for the industry and its customers over the long term.

[1] See for example page 5 of Ofwat's consultation: "Our proposals associated with benefit sharing apply only to highly geared companies" and, on page 4: "…our proposals are specific to those companies with gearing above the notional level."

Putting the sector back in balance – UU response

Continued incentives to outperform mean that more efficient financing costs can continue to make a meaningful contribution to overall outperformance and hence the scope for benefit sharing with customers.

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

Yes. For PR19 we consider that intervention from Ofwat is desirable and necessary where companies propose highly geared structures which do not provide an appropriate level of customer benefit. Such structures have proven damaging to public perceptions of the sector and hence the level of trust and confidence in it. Where companies are unwilling to address this themselves, then proportionate regulatory intervention is justified.

United Utilities has maintained one of the lowest levels of gearing in the sector, particularly post adjustment for pension deficits, over a sustained period of time. Accordingly, customers in our region have not been subjected to the risks associated with high leverage and the company has not profited from them. We therefore do not expect that such interventions would need to be applied to UU.

It is important that investors looking at the sector from the outside are persuaded that regulatory intervention is both legitimate and proportionate if they are to retain trust and confidence in the regulatory model.

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

We support the high level approach presented by Ofwat in its consultation and believe it to be workable.

In establishing the level of gearing in this context, we consider that pension deficits should be recognised as a form of debt. Responsibly financed companies will recognise pension deficits as a long-term liability that ultimately must be settled.

The IFRS valuation of a company pension deficit is a measure that can be consistently applied across the sector. Although the IFRS measure is unlikely to capture the full value of deficits, use of it would provide a first-line check that customers' long term interests are being protected. This is because it gives visible assurance that – when making decisions about gearing – companies must also give consideration to the existence of future funding obligations to meet commitments made to employees. A normalised estimate of the pension deficit would provide an even more robust measure of gearing.

When defining a "highly geared" company, the "gearing difference" buffer should be set at a reasonable margin above the 60% assumption for the notional company. This allows scope for companies to manage short term fluctuations in gearing, as referenced in Ofwat's consultation. The table below summarises guidance from the Moody's credit rating agency in relation to gearing and other metrics which drive credit ratings.

Table 2: Published guidance on credit metrics

	Net Adj Debt / RAV	FFO – IRC & CCD / Net Interest	RCF / Net Adj Debt
A1	>40% <50%	>2.5 <3.5	>14% <18%
A2	>50% <60%	>1.8 <2.5	>10% <14%
A3	>60% <68%	>1.6 <1.8	>8% <10%
Baa1	>68% <75%	>1.4 <1.6	>6% <8%
Baa2	>75% <85%	>1.2 <1.4	>4% <6%

Source: Moody's published research

Moody's current guidance is that gearing could be as high as 74% and still be consistent with a Baa1 investment grade credit rating. An A3 rating, one notch above investment grade, requires gearing of less than 68%.

Moody's has indicated that it might revise this guidance for individual companies or the sector as a whole as the PR19 process evolves if, for example, Moody's perceives an increase in business risk given potentially greater cash flow volatility and/or companies are less likely to achieve allowed returns due to additional cost efficiency and performance challenges.

Even at 60% gearing, variations of 2-3% due to the phasing of capital investment and 2-3% due to fair value adjustments for debt and derivative instruments are possible. We therefore consider that the incentives for sharing the benefits of high gearing should apply to companies once they reach 68% gearing. This level of gearing is consistent with current requirements for an A3 rating and therefore provides a margin of safety in the event that guidance was tightened and – for example – the metrics currently required for an A3 rating now only supported a Baa1 rating for an individual company or the sector. Consistent with Moody's definition, this 68% threshold should include the IFRS valuation of pension deficits where applicable to provide confidence that companies are giving consideration to these liabilities in assessing their gearing targets. Alternatively, inclusion of a normalised measure of pension deficits would provide an even more robust benchmark.

A 68% level of gearing provides an 8% point buffer above the notional level of gearing, including pension liabilities. This compares with Ofwat's proposal of a 5% point buffer, excluding pension liabilities. It is important that companies are incentivised to use the "gearing difference" buffer to responsibly manage fluctuations in gearing, not to use it as a de facto softer benchmark for notional gearing. Accordingly, sharing financial benefits of high gearing should not be restricted to that element of gearing that exceeds the "gearing difference" threshold.

A company is only likely to reach 68% of gearing as a result of conscious decisions to gear at this level – it is unlikely to be so far from the notional level of gearing by accident. We therefore consider that it would be reasonable, once a company reaches 68% gearing, to require that it shares the financial benefits of all gearing in excess of the 60% notional gearing assumption.

In terms of the more detailed design of the outperformance mechanism we consider that the calculation would be better performed on a real basis (as opposed to nominal) and take account of the notional (rather than actual) cost of debt.

Real or nominal basis:

We support the intention set out at the bottom of page 13 of the consultation document where it is stated that Ofwat does not intend to introduce sharing mechanisms in relation to inflation. Using a nominal basis for the outperformance sharing mechanism would be inconsistent with this position. Furthermore, using a real basis for the nominal cost of equity and cost of debt is simple to achieve: real rates for the notional cost of equity and cost of debt are readily available and the difference between the two is consistent whether considering RPI derived rates or CPI derived rates.

Actual or notional cost of debt:

We would support the use of the notional cost of debt as this is consistent with the notional cost of equity used and is easily observed. It also avoids the complications of calculating an actual cost of debt, where we note for example, that the actual cost of debt quoted in Table 1E of the APR represents a "spot" cost of debt rather than an effective cost of debt for the reporting period.

On this basis we conclude that the most robust, internally consistent and easily calculable and therefore transparent approach, would be to apply the difference in the notional Ofwat allowed cost of equity and cost of debt on a real basis.

Credit rating agencies include any pension deficit on an accounting basis within their assessment of gearing. Pension scheme liabilities are debt obligations and failure to include these in an assessment of debt to RCV gearing creates a perverse incentive not to fund pension schemes deficits.

Definition and reporting of gearing

Regardless of whether Ofwat chooses to use real or nominal calculations and actual or notional cost of debt, it is essential that the calculation (including the definition of gearing) is clearly defined and consulted upon so that whether or not a company is in compliance with the target gearing level can be considered as a matter of fact rather than a matter of opinion. This will also ensure that companies have full awareness of their position vis-à-vis the gearing incentive mechanism before any adjustments are invoked.

In future, Ofwat's proposals mean that the reported gearing level is likely to give rise to financial incentives and penalties through regulatory mechanisms. This means it is essential that the definition of gearing is fully specified and that particular attention is given to reporting gearing correctly in future periods. This will ensure a level playing field for companies in performing against this benchmark and that customers receive a fair share of any financial benefits of gearing, as intended under the mechanism.

Sharing of outperformance

Beyond sharing financial benefits associated with high levels of gearing, further benefit sharing with customers should not be overly focussed on financing outperformance: it should take account of all sources of outperformance in the round. In our AMP7 plan we expect to propose benefit sharing arrangements which are calibrated to the company's overall performance as measured by the Return on Regulated Equity (RORE.) These will reflect a consolidated picture of all areas of outperformance against the regulatory contract, not merely financial outperformance – eg: against the assumed cost of embedded debt. This ensures that customers can benefit from the widest possible range of potential outperformance and that incentives for efficient Treasury management to outperform on the cost of debt are not diminished. These incentives are important drivers of lower financing costs in the sector in the long term.

In addition to the potential for voluntary sharing of outperformance with customers (as has been the case for UUW in AMP5 and AMP6) we consider it could be appropriate to pre-commit to a guaranteed sharing of outperformance with customers where the company's RORE exceeds a certain threshold above the base level assumed in the business plan. Outperformance up to that level could be paid as a dividend to shareholders subject to consideration of financial resilience, any pension deficit and forecast gearing,

If a company wishes to pay an outperformance dividend to shareholders above the RORE threshold then there would be matched sharing of these payments with customers through – for example – reductions in customer bills or investment outside the RCV.

If a company earns outperformance and chooses to forgo the extraction of this outperformance via an enhanced dividend – for example by choosing to reinvest outperformance in the business to drive future improvements for customers and/or the environment – then reinvestment through the standard regulatory RCV mechanism is appropriate. This is consistent with the broader regulatory incentive framework for outperformance incentives and strikes an appropriate balance between shareholders and customers in building future service resilience.

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

We agree that companies should explain their approach to dividend policy as part of their business plans and that this should be considered in the IAP assessment.

Receipt of dividend income is a highly important consideration for equity investors in water companies. We believe that providing there is a robust and fair framework for performance commitments and outcome delivery incentives, investors are able to support the principle that companies should target a base level of dividend which could be adjusted to reflect performance. UUW's dividend policy in AMP6 reflects this approach: it pays a base dividend of 5% of the equity proportion of the RCV, with any additional returns arising through demonstrable outperformance.

It is important to note that for a variety of practical and legal reasons, companies would be unable to commit to an actual level of dividend payment in submitting business plans. Dividend policy is a matter reserved for the Board and can only be set with knowledge of the final determination. Further, the declaring and payment of dividends can only be appropriately undertaken in view of the company's actual financial performance and the broader circumstances that prevail at the time. However, this need not be a bar to explaining companies' approach to the policy and the factors that Boards will consider before approving dividend payments.

Where a company's actual gearing is within a normal range between 60% and 68% gearing, then a responsible base dividend policy would balance distributions to shareholders with the retention of profits within the business to manage resilience. We note Ofwat's analysis that a base dividend in excess of 5% of the equity proportion of the RCV would need to be carefully justified for AMP7.

Where a company's actual gearing is – or is forecast to be – substantially in excess of the notional assumption (for example, 68% or more including consideration of the IFRS position on pension liabilities) then dividend retentions should be considered as a potential means of restoring gearing to more normalised levels.

Where a company's actual gearing is below the notional gearing assumption, then it should be able to make additional dividend distributions to shareholders up to and including the full nominal allowed cost of equity (7.13% assumed for AMP7) or the full amount of profit after tax – whichever is greater - in order to optimise its capital structure at the notional level of gearing (60%.) Recognising this point is important for three reasons.

Firstly, it reduces the risk that shareholders in companies that have supported responsible financing structures are not penalised as a result of modest levels of gearing.

Secondly, it provides clarity that companies are free to seek efficient capital structures where these do not require levels of gearing above the notionally assumed level.

Third, it ensures that in future companies are not disincentivised from retaining profits where they might prudently do so, for fear that such funds becomes irretrievable in the long term.

Putting the sector back in balance – UU response

An overall approach which triangulates gearing, dividends and the sharing of outperformance is summarised in table 1 below. In all cases, stakeholders would be consulted about the application of funds released through outperformance sharing in order to ensure that they were being used in a way that best reflects customer, societal and environmental priorities.

Table 1: Summary of triangulation between gearing, dividends, outperformance and reinvestment

	Gearing <=60%*	Gearing >60%, <68%*	Gearing =>68%*
Base dividend to shareholders	Up to the greater of 100% of PAT or 100% of nominal allowed equity returns embedded in final determination (7.19% assumed for AMP7)	Up to 70% of nominal allowed equity returns – this equals 5% for AMP7	Dividend payments restricted in order to help return gearing to more normalised levels
Outperformance dividend paid to shareholders up to predefined threshold of RORE outperformance**	Outperformance dividends distributable to shareholders subject to explicit assessment of financial resilience, pension deficit and forecast gearing position.		Outperformance retained in order to return gearing to more normalised levels
Outperformance dividend paid to shareholders beyond predefined threshold of RORE outperformance***	Outperformance dividends distributable to shareholders subject to explicit assessment of financial resilience, pension deficit and forecast gearing position Guaranteed matched benefit sharing with customers (eg: bill discounts, investment outside the RCV)		Outperformance retained in order to return gearing to more normalised levels
Outperformance retained in company for improvements in service, resilience or the environment	Retained through standard regulatory mechanisms (eg: investment through Totex menu)		

* Net of IFRS measurement of pension deficit

**The payment of any outperformance dividend would be subject to the company not being in material breach of its statutory obligations.

***The payment of outperformance dividends beyond the predefined RORE threshold would be subject to the company materially meeting its AMP7 performance targets or be alongside committed reinvestment in order to meet these targets.

We support Ofwat's view that the payment of dividends should incorporate explicit consideration of the company's obligations in relation to pension deficits. UUW has taken a long term and prudent view on pension deficit funding, recognising that ultimately obligations to a pension scheme are debt-like and should be funded on a low risk, self sufficiency basis. Companies that do not assess pension liabilities on this basis may ultimately be exposing themselves to risks that are similar to high gearing.

Reflecting the IFRS valuation of the company pension deficit as part of the gearing assessment would provide a first-line check that customers' long term interests are being protected. This is because it gives visible assurance that – when making decisions about gearing – companies must also give consideration to the existence of future funding obligations to meet commitments made to employees. It would also be consistent with rating agencies' assessments of gearing. Normalising these deficits would provide an even more robust assessment.

If pension deficits are not recognised as part of the gearing estimate then companies are less incentivised to pay down pension deficits, in favour of reducing other forms of debt. Indeed, companies could be incentivised to allow pension deficits to increase where funds can instead be diverted to reduce the reported gearing position.

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

We agree with Ofwat that companies should explain their approach to performance related elements of executive pay and that the IAP assessment should assess transparency and the link between executive pay and exceptional delivery for customers.

As recognised by Ofwat, executive pay policy is a matter for companies' independent directors and shareholders and transparency about pay arrangements is important for demonstrating the link between performance pay and performance delivery. UU complies with FTSE100 best practice in this area, with full disclosures on executive pay through the UU Group plc annual report in addition to regulatory reporting requirements.

Performance pay for executive directors is strongly aligned to customer delivery given that targets include customer service (as measured through SIM), delivery against performance commitment/ODI targets and delivery of capital projects on time, to budget and to the required quality ("TCQi"), to the benefit of customers. Targets are based on a mix of long- and short-term time horizons.

Other targets which are utilised for executive performance pay (such as operating profit and total shareholder return) are also subject to direct and/or indirect impact as a result of company performance standards in delivering services to customers. Poor performance leads to both financial and reputational damage for the company and its management. Reputational issues are particularly important for publicly listed companies and their employees as they feed through directly and quickly into share price movements on a liquid equity market; this is not the case for privately owned companies where such issues are only reflected in company valuations on an infrequent basis. It should also be noted that UU's Remuneration Committee has the discretion to reduce unvested executive share awards in certain circumstances such as the when there has been serious reputational damage or serious failure of risk management.

In line with legislation, shareholders have a binding vote on the company's remuneration policy for directors and are consulted when changes to policy are proposed. In UU's case this is a three-yearly cycle.

The current policy was approved at the July 2017 AGM and is intended to apply to July 2020. This means that for a variety of regulatory and legal reasons, it is not possible to provide full detail of all performance pay policies for the period to 2025 through the business plan submission. Furthermore, in order to ensure incentives are appropriately calibrated, it is important to provide scope for such policies to be revised from time to time.

However, as part of the business plan submission UU will be able to provide full details of its current approach to remuneration and the principles it expects to apply going forward. Current remuneration policies are already subject to extensive, assured reporting on an annual basis. Building further on our existing arrangements for executive pay, the company's remuneration committee will be undertaking a full review of how performance based pay to be applied from 2020 onwards is linked to service delivery for customers and we will provide further information on the scope of this review in our business plan submission.

We also believe that it would be highly appropriate for Ofwat to take into account a company's track record in assessing the likely appropriateness and transparency of a company's remuneration policy in the next price review period. A risk based and targeted approach should be utilised, directing most attention towards companies that have shown least transparency or responsibility to these issues in the past.

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

We agree with Ofwat's proposed revisions and the revised wording of question 3 in this test area. We also believe that Ofwat should take into account past company performance in these areas. Companies with a good historic track record have eschewed opportunities to profit from corporate behaviour which has undermined legitimacy. They are setting high standards of governance as a benchmark going into PR19 and are less likely to undermine legitimacy in AMP7. By taking into account companies' track record in these areas Ofwat will ensure that responsible behaviour in the sector is seen to be rewarded.

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

We broadly welcome the additional Ofwat guidance on financial resilience and its assessment as part of the IAP. We are particularly supportive of the Ofwat prescribed common scenarios which will provide a degree of standardisation and relative comparability of financial resilience assessments across the industry, although we agree that companies should also consider additional company specific scenarios which are most relevant to them.

United Utilities was one of the first FTSE100 companies to publish a viability statement through our early adoption of the Combined Code requirements which enabled us to influence best practice across the UK, in conjunction with the FR Lab. As such, we welcome Ofwat's developments in this field and support the expectation that water companies provide robust viability statements for a period of at least 5 years. While we believe a rolling five years is the appropriate period for annual financial reporting we anticipate providing a viability statement running to 2025 when submitting our business plan.

We note the observation in s3.1 that companies with high levels of gearing have potentially lower levels of financial resilience as the impact of cost shocks or poor performance is magnified to a smaller equity base. We believe this should be the first consideration when assessing financial resilience and the scale of the buffer should dictate the amount of supporting justification deemed necessary.

As set out elsewhere in this response, we note that rating agencies adjust debt to RCV gearing calculations for pension deficits and that these are essentially debt-like. We believe Ofwat should therefore consider the equity base after deduction of the pension deficit when considering viability assessments. We consider that the scenarios presented represent a sensible set of extreme downside scenarios to consider and the composite scenario provides a good yardstick of a company's ability to cope when multiple things go badly. One area these could be sensibly enhanced is to capture the risk within the pension scheme where the liabilities are not hedged in an asset liability matching process. A sensible scenario would be a c20% increase in pension liabilities that are not fully hedged for inflation and interest rates to reflect volatility and exposure to rates.

We do not expect to be pushing the financial scenario details within our annual viability assessment, although we will include such analysis as part of our regulatory submission.

