

July 2019

Trust in water

PR19 draft determinations

**Northumbrian Water – Securing confidence
and assurance actions and interventions**

0 f w a t

www.ofwat.gov.uk

PR19 Draft Determinations: Northumbrian Water – Securing confidence and assurance actions and interventions

Following our initial assessment of plans, we categorised two types of actions for slow-track and significant scrutiny companies:

- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery); and
- advised actions for companies to do by a specific date but that are not required for our draft determinations.

Table 1 below sets out the required and advised actions, a summary of the company's response to the action, our assessment of the company's response, and any further interventions we are making as part of the draft determination.

Each action has a unique reference. The prefix 'NES' denotes the company Northumbrian Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Actions whose numbers are preceded with an 'A' denote required actions and actions whose numbers are preceded with a 'B' denote advised actions.

Table 2 below sets out any further interventions that are not resulting from an action which we are making as part of the draft determination.

Each further intervention that is not resulting from an action has a unique reference. The prefix 'NES' denotes the company Northumbrian Water. The central acronym references the test area where the action has been identified, please see the 'PR19 draft determinations: Glossary' for a key to these acronyms. Intervention numbers are preceded with a 'C'.

For all other documents related to the Northumbrian Water draft determination, please see the [draft determinations webpage](#).

Table 1 – Northumbrian Water's response to required actions and interventions for draft determinations

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
Securing confidence and assurance	NES.CA.A1	Required	Provide restated Board assurance that large investment proposals are robust and deliverable, that a proper assessment of options has taken place, and that the option proposed is the best one for customers. The Board's original statement did not confirm that large investment proposals are deliverable.	1 April 2019	Northumbrian Water's Board provides the following updated Board statement: "We have reviewed the company's approach to selecting schemes and projects and the company's capacity to deliver them sustainably in the light of recent performance. This has confirmed that the company's expenditure forecasts are robust and efficient and that all the proposals, including the enhancements and large investment proposals, are robust and deliverable and offer the best available outcome for customers."	No intervention required. The Board of Northumbrian Water provides a compliant assurance statement.	N/A
	NES.CA.A2	Required	Provide restated Board assurance that the Board's governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term. The Board's original statement did not contain forward looking assurance that its	1 April 2019	Northumbrian Water's Board provides the following updated Board statement: "The Board confirms that its governance and assurance processes will deliver operational, financial and corporate resilience over the next control period and the long term."	No intervention required. The Board of Northumbrian Water provides a compliant assurance statement.	N/A

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
			governance and assurance processes will deliver resilience over the next control period and the long term.				
	NES.CA.A3	Required	On gearing benefits sharing the company forecasts gearing close to 70% over 2020-25. It does not commit to applying a sharing mechanism if gearing exceeds 70%. It should incorporate our default sharing mechanism from 'Putting the sector in balance' position statement into its published business plan, so that customers will receive bill reductions if gearing in any year is above the 70% threshold.	1 April 2019	Northumbrian Water confirms that it has incorporated the default sharing mechanism from 'Putting the sector in balance' position statement into our revised Business Plan. Northumbrian Water accepts our mechanism on the basis that all companies have included the same mechanism or equivalent within their draft determination.	No intervention required. Northumbrian Water confirms the default sharing mechanism from 'Putting the sector in balance' position statement has been incorporated into its revised Business Plan.	N/A
	NES.CA.A4	Required	On dividend policy the company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'Putting the sector in balance' position statement to include: clear Board commitment to publish detail on dividend policies in the APR and to signal changes to stakeholders; and commitment to transparency about how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends. Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.	1 April 2019	Northumbrian Water confirms that it is committed to adopting all of the expectations on dividends for 2020-25 as set out in 'Putting the sector in balance' position statement. It has committed to transparent disclosure of its dividend policy in its Annual Performance Report each year and will clearly highlight for stakeholders any changes made to the policy. It also confirms that when setting its dividend level, it will fully consider whether obligations and promises to customers have been met.	No intervention but further action needed by Northumbrian Water. The company provides sufficient evidence of its intention to meet the expectations on dividends as set out in 'Putting the sector in balance' position statement but its response lacks detail on how it will demonstrate annually to stakeholders that it has met them. It provides insufficient transparency as to: <ul style="list-style-type: none"> the specific obligations and commitments to customers; the level of performance delivery they will be considered against; and how they will impact on dividends. The company refers to its stated base dividend yield in its business plan as a 'modelling assumption'. Our 'Putting the sector in balance' position statement set out an expectation that companies need to state 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 expect Northumbrian Water to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our position statement. We expect the company to respond to this issue in its response to our draft determination. We expect the company to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. In doing so, the company should refer to the examples of best practice we have identified among companies. We also expect the company to clarify its proposed base dividend yield for the period 2020-25.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	NES.CA.A5	Required	<p>On executive pay the company is required to confirm that it is committed to adopt the expectations on performance related pay for 2020-25 as set out in 'Putting the sector in balance' position statement to include:</p> <ul style="list-style-type: none"> - providing full details and commitment to publish, including all performance metrics, the executive pay policy for 2020-25; - visibility and evidence of substantial linkage of executive remuneration to delivery to customers; - clear explanation of stretching targets and how they will be applied; - clear explanation of how the policy will be rigorously applied and monitored; and - clear commitment to transparency of reporting. Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement. 	1 April 2019	<p>Northumbrian Water states that its remuneration committee has always given thorough consideration to the approach and strategy for the remuneration of its executive directors, and that although the current strategy has been in place for a number of years, it is reviewed annually.</p> <p>The company did not meet our expectations, as set out in our 'Putting the sector in balance' position statement, in its response to the action in the initial assessment of business plans. We raised a detailed query with the company and the summary below is based on the information the company provided in response. The company sets out the policy for 2020-25 has been amended, to include:</p> <p>short term bonus based on 50% customer focused measures (10 metrics with a weighting of 5% each including for example C-Mex, interruptions, water quality, leakage and pollution incidents) and 50% competitiveness (25% earnings before interest and tax and 25% shareholder distributions)</p> <p>long term bonus based on 50% RoRE and 50% shareholder distributions.</p> <p>targets set by reference to performance levels which are industry leading, or leading outside the sector, rather than be constrained by its business plan.</p> <p>the remuneration committee having responsibility for setting the targets for both schemes each year, taking into account what industry leading performance looks like, and for reviewing performance against the policy and determining the awards for both schemes.</p> <p>full reporting of the details of the policy in the annual performance report, including any changes to the policy and the underlying reason for the change.</p> <p>The company states that the revised policy will take effect from 2020, and has been approved by the remuneration committee.</p>	<p>No intervention but further action needed by Northumbrian Water.</p> <p>The company's proposed policy demonstrates the company's commitment to move in the direction of the expectations set out in 'Putting the sector in balance' position statement.</p>	<p>There remain some details to be finalised, for example evidence of how the targets in the long term bonus will be stretching and further evidence to demonstrate alignment of incentives to substantial delivery for customers. Once finalised, we expect Northumbrian Water to provide an update in its response to the draft determination to demonstrate that it is committed to meet the expectations we have set out in 'Putting the sector in balance' position statement.</p> <p>We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25.</p> <p>We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.</p>

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
	NES.CA.A6	Required	Provide a revised financial model (based on version 16z released on 31 January 2019) and data tables on 1 April 2019.	1 April 2019	Northumbrian Water provides a revised financial model based on version 17z (as communicated to companies since the initial assessment of plans action was set) and data tables.	No intervention required. Northumbrian Water provides a satisfactory response to this action.	N/A
	NES.CA.A7	Required	Provide more information in table App1 associated with the six 'underperformance payment only' PCs that are based on the timely delivery of enhancement programmes i.e. table contains no incentive rate, deadband, cap/collar, max penalty, P10 values for these PCs.	1 April 2019	Following subsequent engagement, Northumbrian Water provides information in App1 related to the six 'underperformance payment only' performance commitments that are based on the timely delivery of enhancement programmes	No intervention required. Northumbrian Water provides sufficient information in response to this action.	N/A
	NES.CA.A8	Required	There is inconsistency between the notional cost of equity in financial model and data tables. The company should ensure its subsequent submission is consistent in this respect.	1 April 2019	Please refer to NES.RR.A3 for details of Northumbrian Water's response to this action and our assessments and rationale.	No intervention required.	N/A
	NES.CA.A9	Required	On voluntary benefit sharing, the company should provide more specific detail on how its unutilised tax funding will be invested to provide lasting customer benefits.	1 April 2019	Northumbrian Water clarifies that it will share the notional interest income on £50 million of hitherto unutilised tax funding to support targeted customer support initiatives. Sharing payments from this mechanism will be based on applying a rate derived from the actual interest rates received on cash investments through the year. The company will report this sum and how this funding has been used in its Annual Performance Report each year. No intervention required.	Northumbrian Water provides a satisfactory response to this action.	N/A
	NES.CA.B1	Advised	Provide an updated financial model that: contains allowed revenue k factors that are consistent with the business plan tables does not overwrite the CPI(H) + RPI wedge calculation within the financial model and uses the wholesale cost of equity to calculate dividend yield. In addition, provide revised tables Wr3, Wn3, WWn5 and Bio4 completed using a notional structure as required.	1 April 2019	Northumbrian Water confirms that all advised actions have been completed. However, the k factors in the submitted model do not match those in the data tables due to the company including in its data table App7 pure revenue growth before deducting CPIH. The company's submitted model does not overwrite the CPI(H) + RPI wedge calculation and uses a dividend yield of 4.52% and growth of 0%. The company submits revised tables Wr3, Wn3, WWn5 and Bio4 using a notional structure.	Intervention required. Northumbrian Water provides an unsatisfactory response to this action as the combined dividend yield and growth are below our early view of the real (CPIH based) cost of equity.	We are intervening to use our view of dividend yield and growth.

Table 2 – Further interventions for draft determinations

Intervention reference	Our assessment and rationale	Interventions
N/A	N/A	N/A

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.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gov.uk

July 2019

© Crown copyright 2019

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gov.uk.

