Monitoring financial resilience

Ofwat

January 2020

Introduction and context

Introduction

Water companies are required to report performance information in their Annual Performance Reports ("APRs") . This includes information about their financial returns and resilience both now and in the longer term. This report draws on information published by individual companies[1] in their APRs for the year ended 31 March 2019 and other publicly available information (e.g. statutory accounts published by individual companies or reports from the credit rating agencies).

This report is intended to enhance the visibility and accessibility of each company's financial performance and the financial structures in the sector by sharing key metrics, rather than drawing any conclusions on the financial performance of any individual company. This enables Ofwat and other stakeholders (including investors and potential investors, ratings agencies, analysts, government and customers) to monitor the businesses which we regulate and to challenge the sector in its identification and management of risk.

While this report does not draw any conclusions on the financial performance or resilience of any individual companies, in line with our strategic goal to transform water companies' performance, we continue to engage with companies directly where we have concerns about their financial or operational performance or where we see indicators of a risk to their financial resilience. Further details of our strategic goals can be found in our document 'Time to act, together: Ofwat's Strategy'.

Context

The year ended 31 March 2019 is the fourth and penultimate year in the current regulatory review period, PR14. We published the final determinations for PR19, the price review for the 2020-25 period, in December 2019.

On 1 July 2018 variations were made to the Appointments of Severn Trent and Hafren Dyfrdwy (formerly Dee Valley Water; referred to as Hafren in this report for all years) so that activities within Wales are now undertaken by Hafren and activities within England are now undertaken by Severn Trent. This has also resulted in Hafren undertaking wastewater services for the first time[2].

Regulatory investigations

On 8 August 2018 we confirmed that we had imposed a £1 penalty on Thames and published the undertaking Thames provided that formalised its package of financial and non-financial commitments, worth £120m to customers. In the year ended 31 March 2019, as part of this package, Thames returned £40.3m to customers by reducing customers bills.

On 10 October 2019 we confirmed that we had imposed a £3m penalty on Southern and published the undertaking Southern provided that formalised its package of financial and non-financial commitments, which included returning £123m to customers. Southern's 2018-19 accounts included a provision of £138.5m (reflecting outturn prices) in relation to this.

Where relevant in this report, we have highlighted where these commitments have impacted these companies metrics.

Contents

The metrics considered on the following pages are:

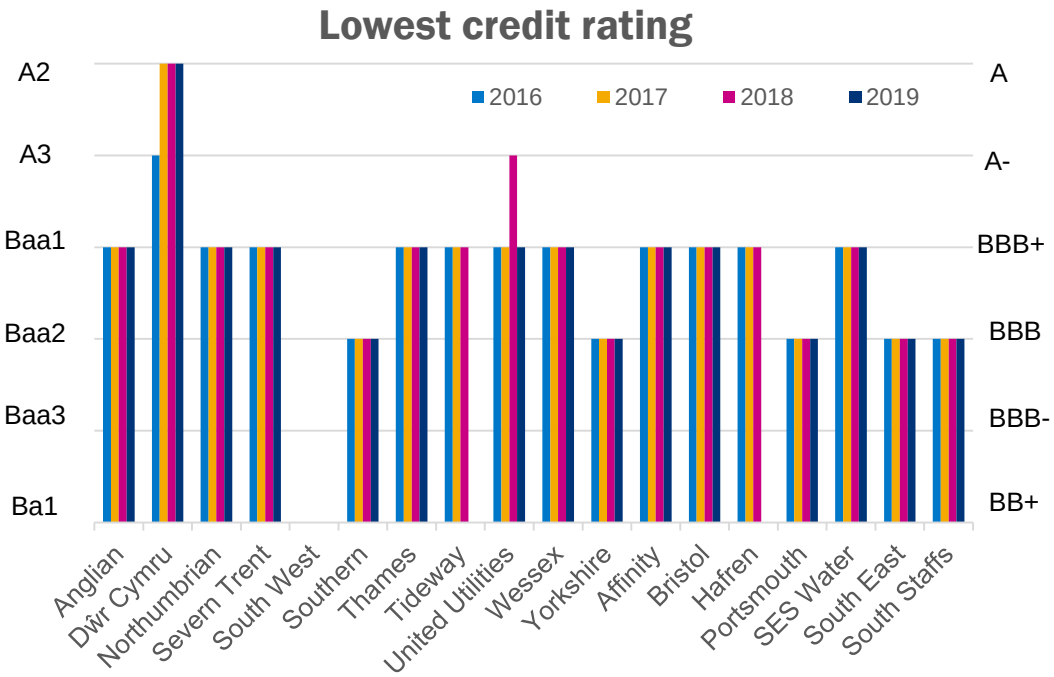
Along with supporting appendix:

Number references used throughout this report link through to further detail available at the end notes pages:

The delivery of the outcomes that were outlined in each company's final determination at PR14 are reviewed in more detail in our Service and delivery 2018-19 report.

The supporting data tables for the graphs included within this report have been published on our website.

Credit ratings



Most companies' licences include a requirement with respect to maintaining an investment grade credit rating[3]. All the companies with this requirement currently have credit ratings that are at least at the minimum investment grade level (BBB/Baa3).

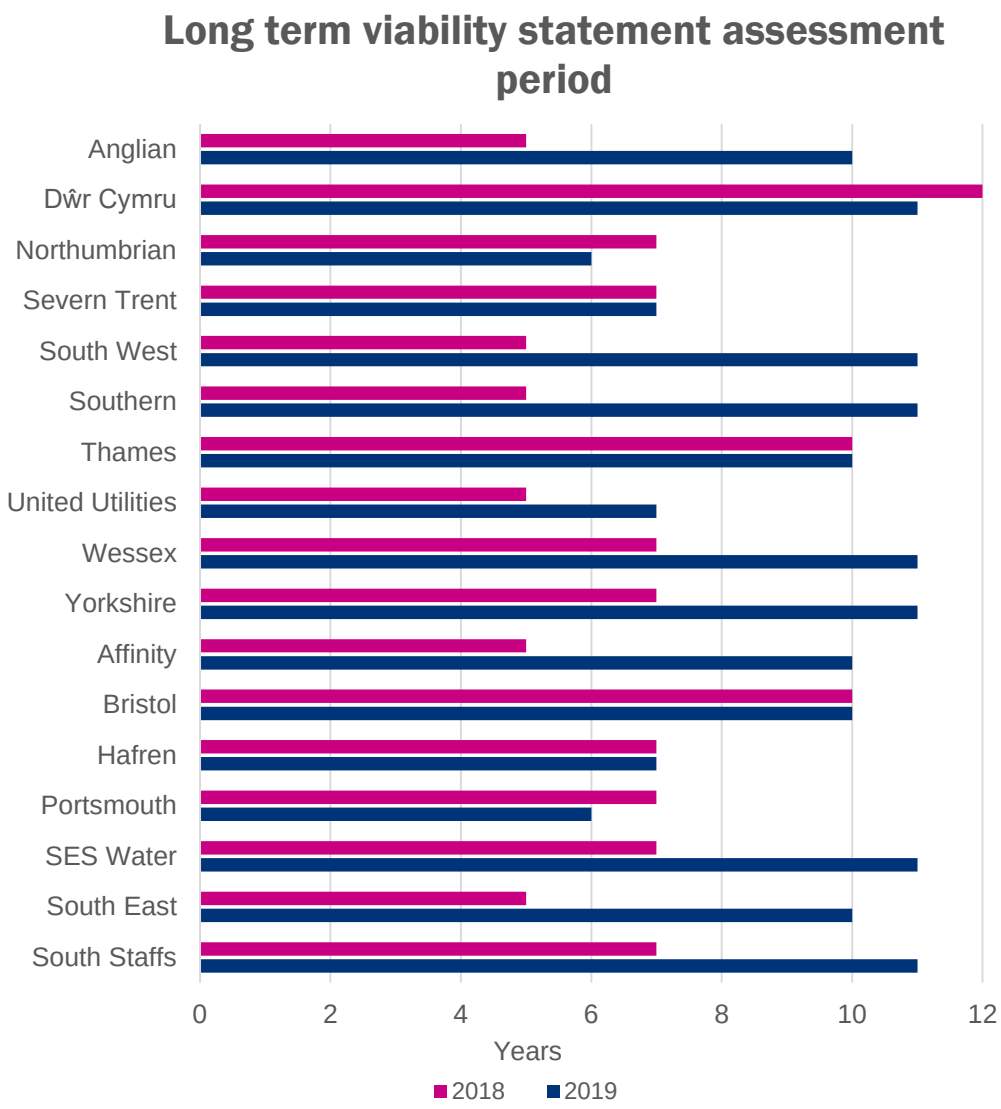
Typically, each company maintains a credit rating with one or more of Moody's, S&P and Fitch. The credit ratings shown in the chart reflect those reported in the Annual Performance Report, which requires the lowest rating to be reported where a company is rated by more than one agency. South West and Hafren's licences do not require them to maintain a credit rating. However, their licences require them to maintain financial ratios that are equivalent to an investment grade credit rating.

The graph shows the lowest credit rating position as stated in companies' APRs. At 31 March 2019, the majority of the industry had its lowest credit rating on negative outlook. As at 31 March 2019, other than South Staffs, all of the companies at the Baa2/BBB level were on negative outlook.

Between 31 March 2019 and the publication of the APRs on 15 July 2019, Moody's downgraded Southern from Baa1 to Baa2 as a result of their operational failures, but kept them under review. For transparency, Southern chose to report this value in their APR and therefore we have included it in the chart.

Post publication of the APRs, Moody's completed their review of Southern Water's credit rating and downgraded them from Baa2 to Baa3, changing their outlook to stable. Moody's also changed the outlook of South Staffs Baa2 rating from stable to negative.

Following the publication of our final determinations on 16 December 2019, Moody's and Fitch both indicated that they would be reviewing the credit ratings of a number of companies for potential downgrade. At the time of publication the outcome of these reviews is not known. S&P have also signalled that they expect to take rating actions early in 2020.



Companies are required to undertake an assessment of long term viability which covers an appropriate forward looking period, and submit a statement which evidences this assessment and how they have concluded on the long term viability of the company.

Companies are responsible for ensuring that they choose an appropriate assessment period and provide clear justification as to why their chosen period is appropriate.

We expect the assessment period to be at least 5 years, and challenged companies to look beyond the end of the next price review period (2020-25).

A stepped increase was noted overall in the length of companies' assessment periods this year compared to last year. All of the long term viability statements made by companies this year looked forward to at least 2025, meaning the minimum period over which companies assessed was 6 years, compared to 5 years last year. Twelve companies went further and assessed financial resilience over at least ten years, compared with four that did so last year.

Our Expectations for companies in issuing long term viability statements information notice, published in April 2019, detailed our expectations for companies in preparing their long term viability statements.

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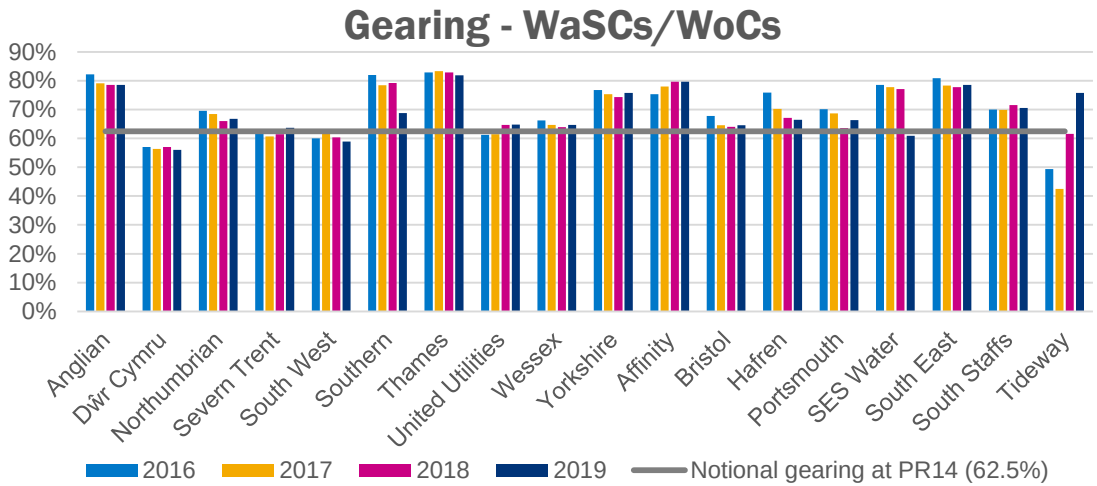
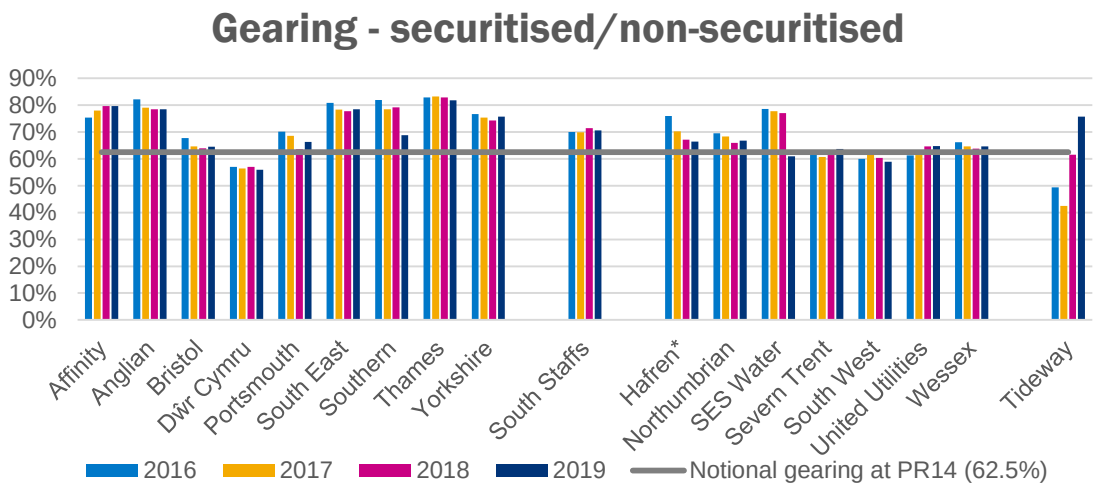
Gearing





*Hafren was securitised up until its acquisition by Severn Trent

As discussed within our 'Putting the sector in balance: position statement on PR19 business plans'[4], higher gearing means equity investors can generate higher returns for a given level of performance.

A high level of gearing also arguably reduces a company's resilience to cost shocks as it usually commits the company to paying higher overall interest costs due to the higher debt levels. Therefore, we encourage companies to consider whether high levels of gearing are sustainable.

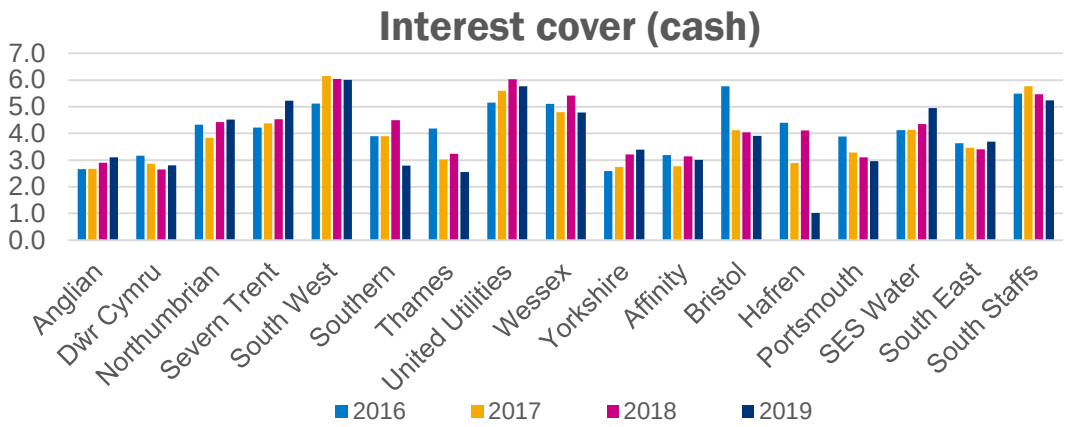
Southern and SES Water have taken steps to reduce their levels of gearing through equity injections in the year. Hafren also received an equity injection, however this has been offset by their reduction in RCV following the Severn Trent acquisition[2].

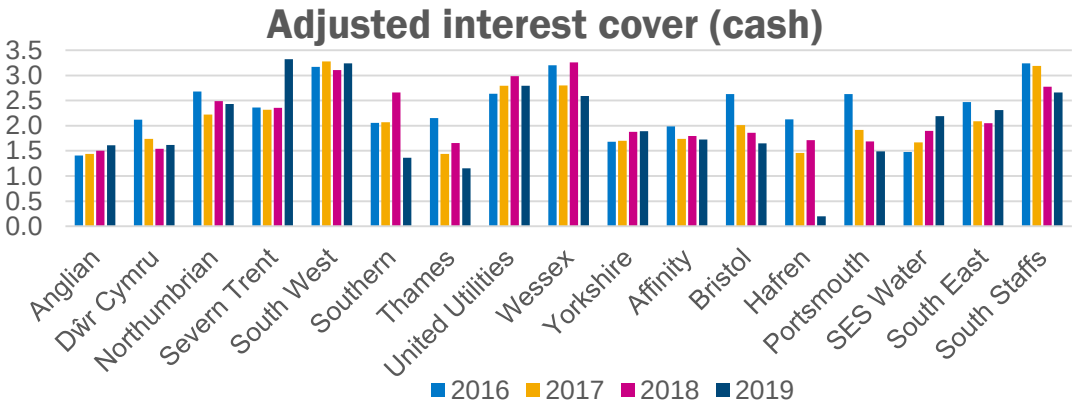
The increase seen in Tideway's gearing in 2019 reflects an increase in debt financing as Tideway deliver their investment programme.

Otherwise gearing levels remained broadly unchanged year to year.

Regulatory gearing is the ratio of net debt for the appointed business to its regulatory capital value (RCV). Net debt includes preference share capital and shareholder loans, it excludes any pension deficit liability and mark-to-market accounting adjustments. For AMP6 (2015-20) we have assumed a notional capital structure with a notional gearing level of 62.5%. For AMP7 (2020-25) notional gearing has been set at 60%.

Interest cover





Interest cover ratios are an indicator of the relative financial strength of a company. Interest cover is impacted directly by factors such as each company's actual debt costs and operational performance.

Hafren's interest cover ratios for 2019 have been impacted by the company's increased operating costs in 2019, which were driven by two main factors; Hafren's region being more rural and more expensive to serve following the boundary changes[2], and Hafren's increased investment in its network. Close to year end, Hafren restructured its financing to reduce its finance costs to a more sustainable level.

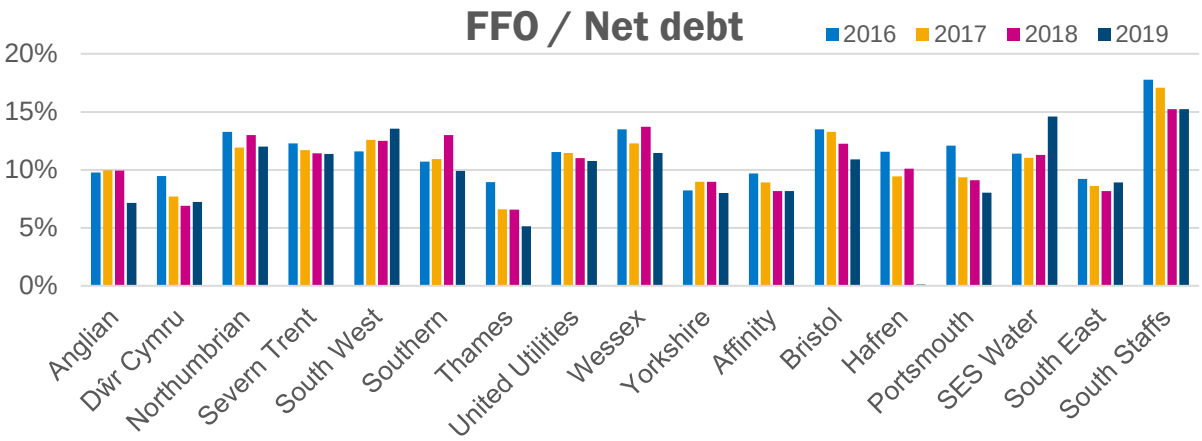
Severn Trent's adjusted interest cover ratio has been impacted by the reallocation of their RCV[2]. Severn Trent's regulatory depreciation for 2019 is relatively low following this reallocation, this has led to the increase seen in their adjusted interest cover ratio in 2019.

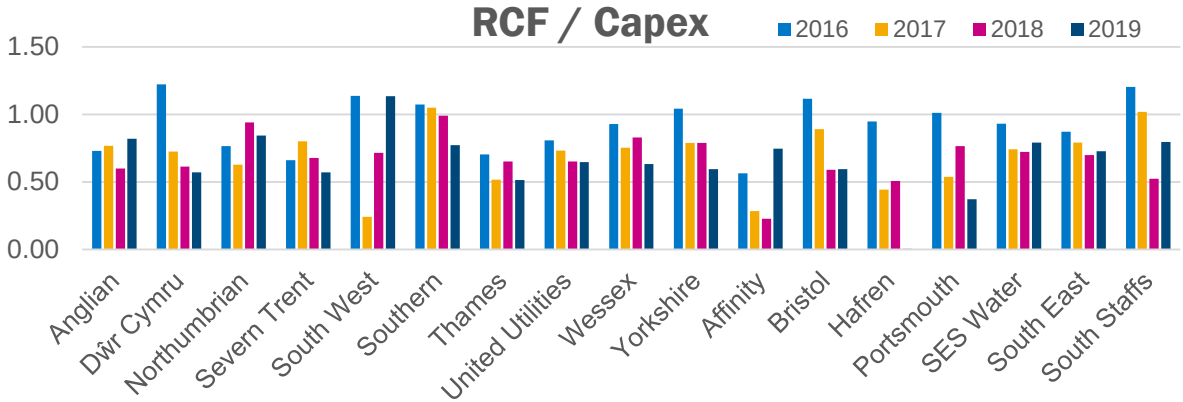
Interest cover ratios illustrate a company's ability to pay interest on its debt. Companies have provided two interest cover ratios in their APRs and these metrics are also used in Ofwat's assessment of financeability during price reviews.

The interest cover ratio looks at the ratio of funds from operations (FFO) before the payment of interest to cash interest paid. In the adjusted interest cover metric, the numerator is adjusted to subtract regulatory depreciation which is an approximation of the capital cost that would be incurred if companies were to maintain the RCV at a constant level.

Anglian presented their financial metrics up to 2018 excluding certain internal transactions[5], this resulted in lower FFO and lower interest cover metrics. The company's metrics are shown in the charts above excluding these transactions, as presented by the company.

FFO/Debt and RCF/Capex





The FFO/Net Debt and RCF/Capex metrics look at the ability of companies to repay their debt and to fund their capital expenditure requirements.

FFO/Net Debt and RCF/Capex are two financial ratios that are monitored by credit rating agencies.

Hafren's FFO/Net Debt ratio and RCF/Capex ratio for 2019 are both nil (rounded to 2dp), these ratios have been impacted by the company's increased operating costs in 2019. Hafren's increased operating costs in 2019, were driven by two main factors; Hafren's region being more rural and more expensive to serve following the boundary changes[2], and Hafren's increased investment in its network.

Funds from Operations (FFO)/Net Debt is calculated as FFO (cash generated from operating activities adjusted to remove changes in working capital, less net interest paid and tax paid) as a proportion of net debt. It indicates each company's ability to repay its debt.

Retained Cash Flow (RCF)/Capex is the ratio of retained cash flow (FFO less total equity dividend paid) as a proportion of gross cash paid in relation to fixed assets. It relates to a company's ability to meet its capital expenditure requirements.

Anglian presented their financial metrics up to 2018 excluding certain internal transactions[5], this resulted in lower FFO and in 2018 resulted in higher RCF. The company's metrics are shown in the charts above excluding these transactions, as presented by the company.

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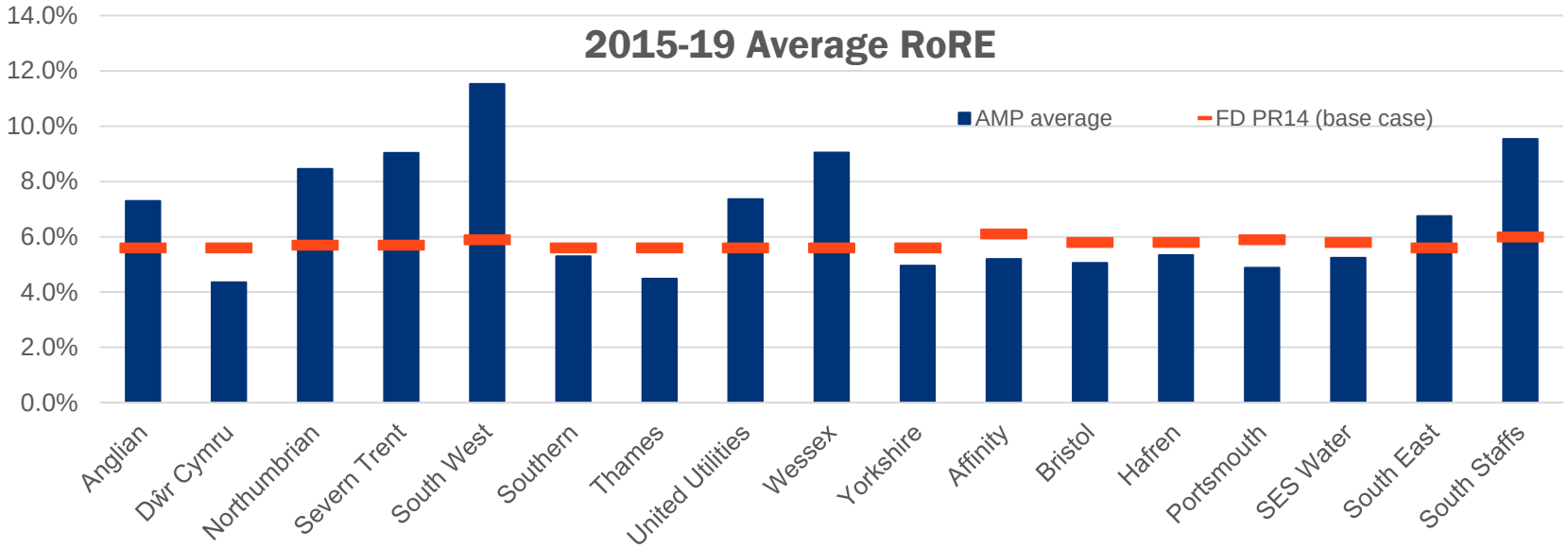
Return on Regulatory Equity (RoRE) (1)



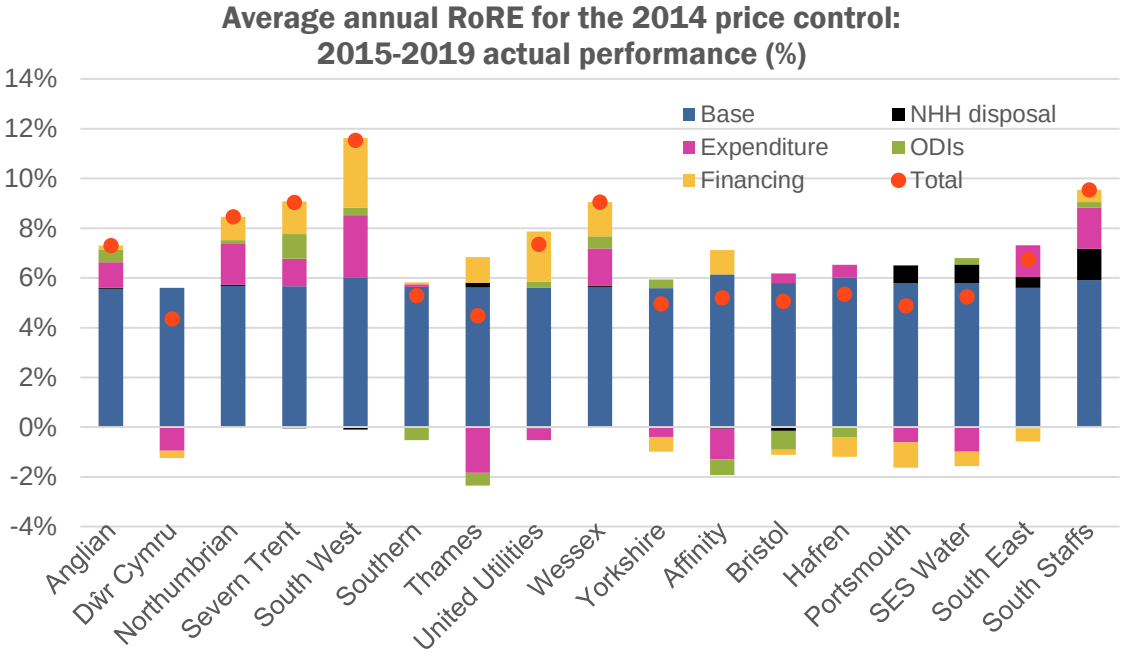
The base RoRE for each company at PR14 (shown by the red line in the chart) represents the return a company would earn if its performance was in line with the assumptions included in our price determinations and assuming that companies are geared in line with the notional capital structure.

Variances are driven by both operational and financial performance. Further analysis of the individual components of this performance is shown on the next page.

Eight companies have reported an average RoRE in excess of their base RoRE, while nine companies have reported an average RoRE below the base level.

Return on Regulatory Equity (RoRE) measures the returns (after tax and interest) that companies have earned by reference to notional regulatory equity, where regulatory equity is equal to 37.5% of the RCV. The calculations presented are the responsibility of company management and have not been verified by Ofwat. The calculations require an element of judgement by company management particularly in relation to expenditure where companies have to determine whether any over or underspend in each year amounts to genuine additional costs or cost savings or is simply due to re-profiling of expenditure within the current price control period.

Return on Regulatory Equity (RoRE) (2)



This chart shows the sources of companies' out/underperformance.

RORE variances across the period for specific items were:

Expenditure – range -1.83% to +2.53% (average +0.31%);

Financing – range -1.02% to +2.81% (average +0.42%);

Service incentives – Outcome delivery incentives (ODIs) range -0.76% and +1.00% (average +0.04%);

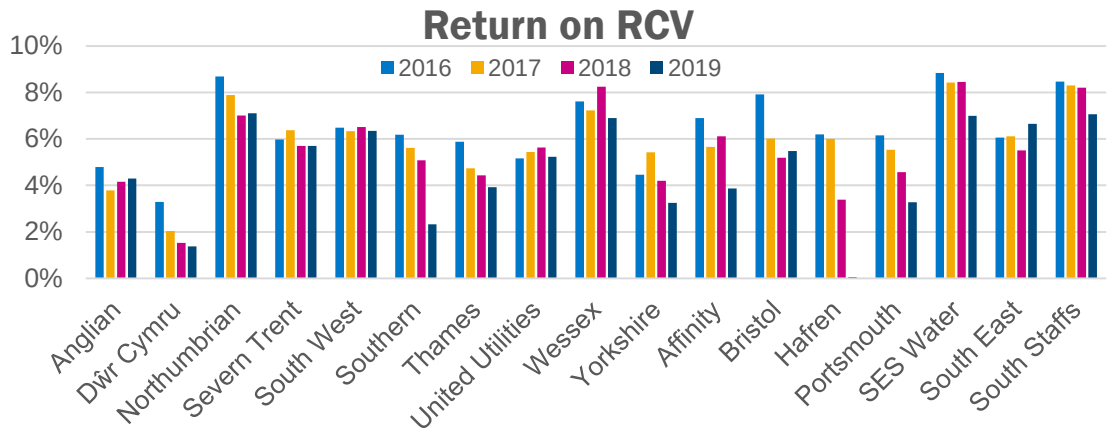
NHH Disposal – Range -0.15% to +1.26% (average +0.18%).

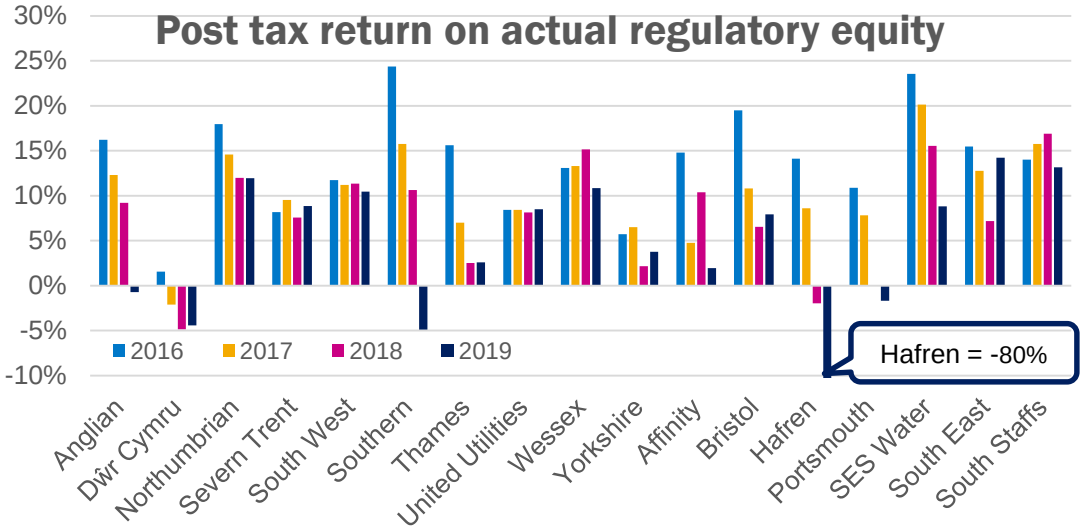
Where a company has not exited the Non-household retail market as of 31 March 2019 (see page 21 for more information), there will be no impact to RoRE for the NHH disposal line. All companies that have exited will have made some adjustments to their RoRE to account for this, however, in some cases this impact will be negligible depending on the difference between the profit on sale and the reduction in returns from no longer participating in the market.

Outturn RoRE performance is impacted primarily through:

- Base RoRE – This is the base return as set out in company's final determination.
- Financing – where companies out or under perform the cost of debt assumed in price determinations
- Operational performance is reflected through a company's performance against expenditure allowances and their Outcome Delivery Incentives (ODIs). ODIs incentivise companies to deliver high levels of service to customers by providing rewards or penalties against performance commitments. At the performance commitment level, the ODI impact to RoRE will be 0%.
- Cost out or under performance - companies are incentivised to deliver wholesale and retail services at efficient cost by retaining some of the financial benefits of outperformance. For retail services the entire financial benefits of outperformance are kept by the company, but for the wholesale service a portion of the financial benefits are shared with customers.
- NHH disposal – There is an impact to company's RoRE to account for the reduction in returns from no longer being in the NHH retail market and the one off exceptional item relating to the sale proceeds companies received when disposing of their NHH business.

Return on RCV/Post tax return on regulatory equity





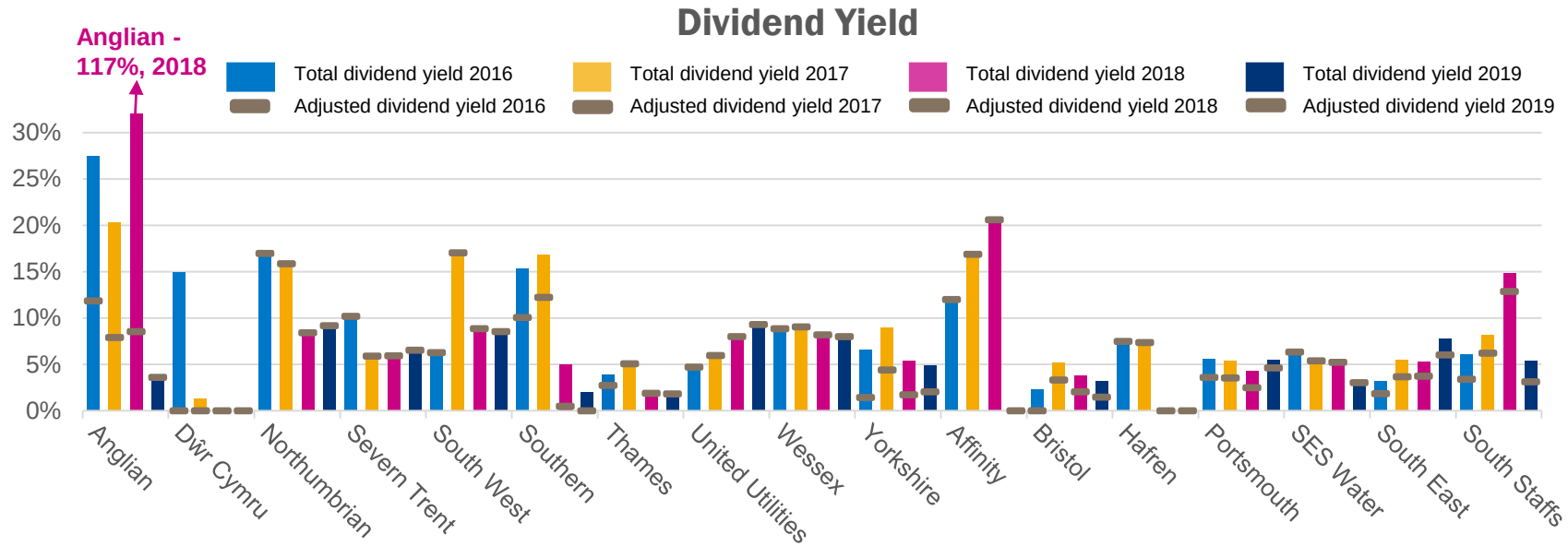
Those companies which have returned revenue to customers via lower bills (e.g. Dŵr Cymru) and those companies which have incurred additional costs (e.g. Southern and Hafren) have seen a negative impact on their returns.

Anglian also had a large reduction in their post tax return this year. This is due to them no longer receiving interest from their intra-group loan. As this refers to interest only, it does not impact their return on RCV measure.

In 2019 Hafren had an exceptional financing cost linked to their de-gearing exercise. This led to a significantly negative post-tax return on actual regulatory equity. In 2018, Hafren's return reduced due to an increase in current tax due to a prior year adjustment agreed with HMRC.

Return on RCV is calculated as profit for the year before interest less current tax, divided by the average RCV for the year. Post tax return on regulatory equity is calculated as profit after interest but before fair value movements, less current tax; taken as a percentage of average regulatory equity. In this metric regulatory equity is RCV less actual net debt. Company's with a higher level of gearing will have a lower level of regulatory equity. This will cause the post-tax return on actual regulatory equity to be more volatile year on year.

Dividends



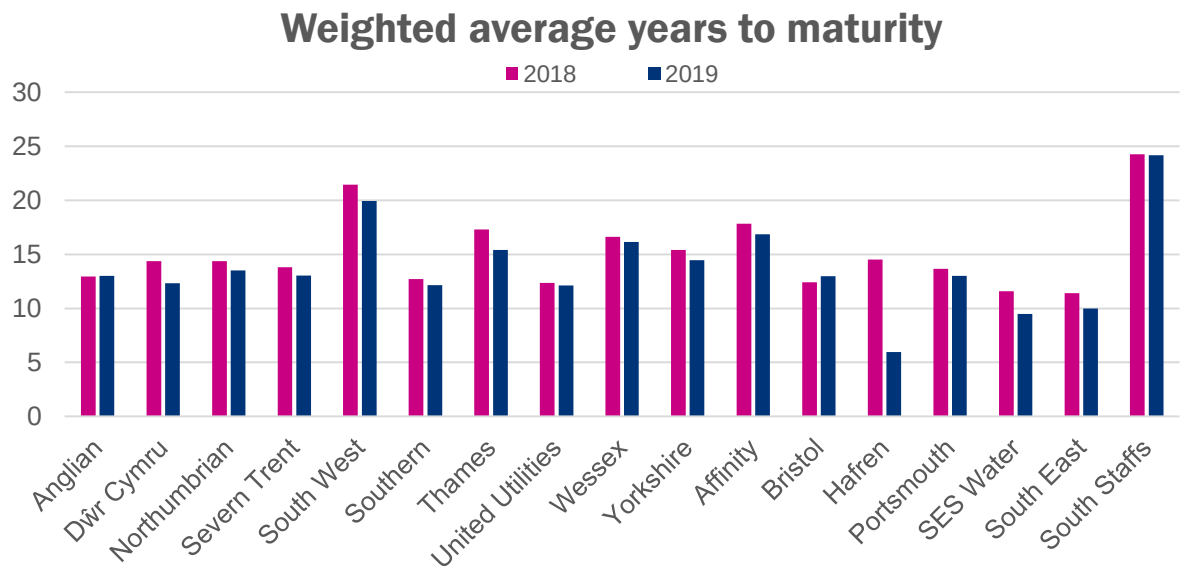
The chart above shows adjusted dividend yield, which is the dividend yield published in companies' APRs. This is calculated as adjusted appointee dividend (see paragraph below for further details) as a percentage of actual regulatory equity. The chart also shows total dividend yield, which is not included in companies' APRs. This metric has been calculated as total appointee dividend (before adjustment) as a percentage of actual regulatory equity. This has been presented to provide transparency around the total appointee dividend and the adjustments made.

Adjusted appointee dividend is the total appointee dividend less dividends paid to a holding company to enable that company to pay interest on and/or make a repayment on intra-group loan from the appointee. Companies who have paid dividends for such purposes, and therefore show an adjusted dividend yield and total dividend yield in the chart include; Anglian, Bristol, Portsmouth, South East, Southern, South Staffs, Thames and Yorkshire. Due to Dŵr Cymru's ultimate parent undertaking being limited by guarantee and therefore having no shareholders[6], its adjusted appointee dividend yield is deemed to be nil.

Variations in dividend yields reflect the circumstances and dividend policies of each company. The average adjusted dividend yield in 2019 across the sector was 3.9%, compared to 5.8% in 2018. The average total dividend yield in 2019 across the sector was 4.6%, compared to 13.1% in 2018. Anglian's higher total dividend yield in 2018 reflects that its total appointee dividend included £1,602.6m, paid to its holding company to enable that company to repay its intra-group loan from Anglian. Higher dividends paid by Affinity and South Staffs in 2018 resulted from the sale of non-household retail businesses.

We expect companies to be clear and transparent about the dividends they pay and how they reflect the performance of the company and delivery for customers, for more information see our Putting the sector in balance: position statement on PR19 business plans.

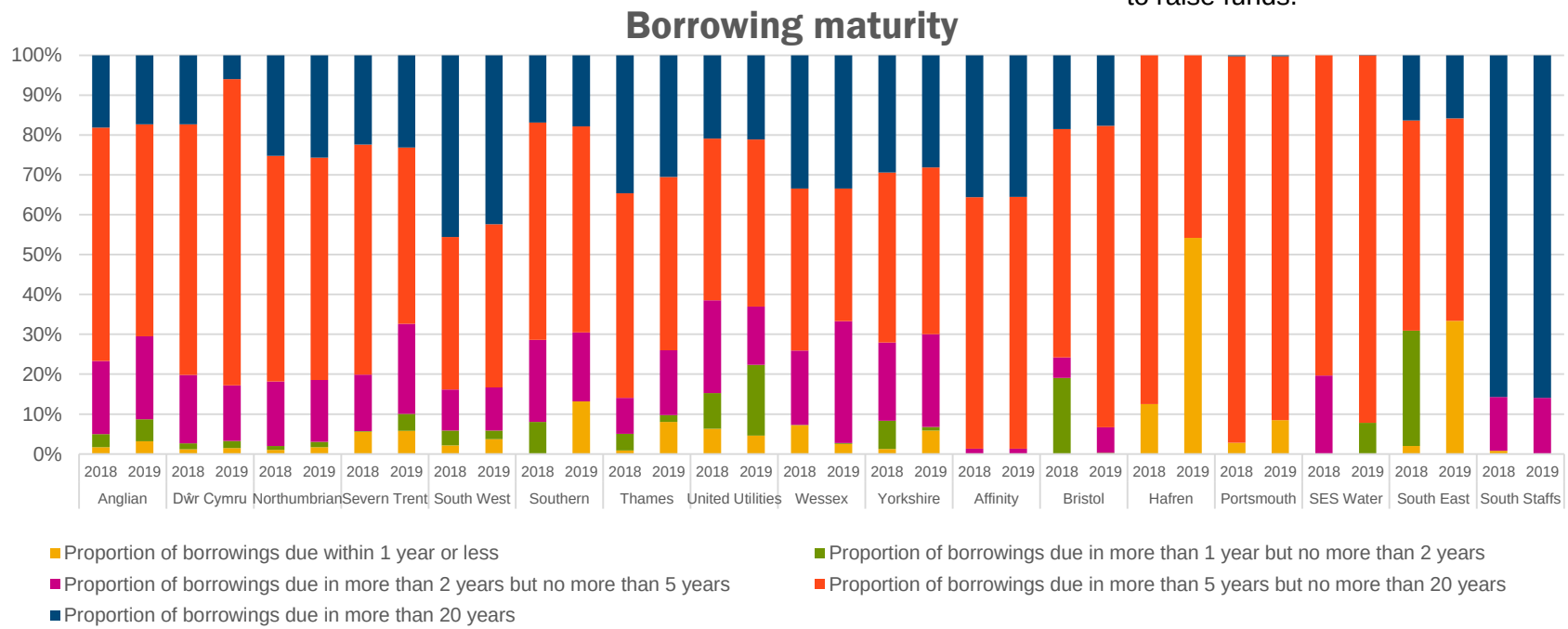
Maturity of company debt



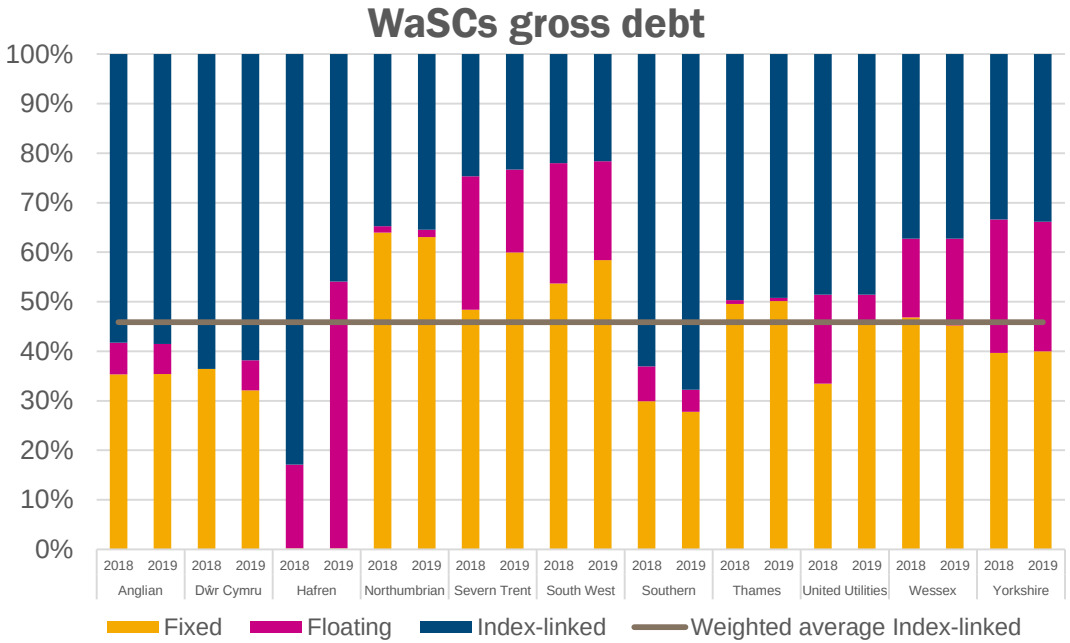
Companies use a portfolio of both long and short term debt to finance their business.

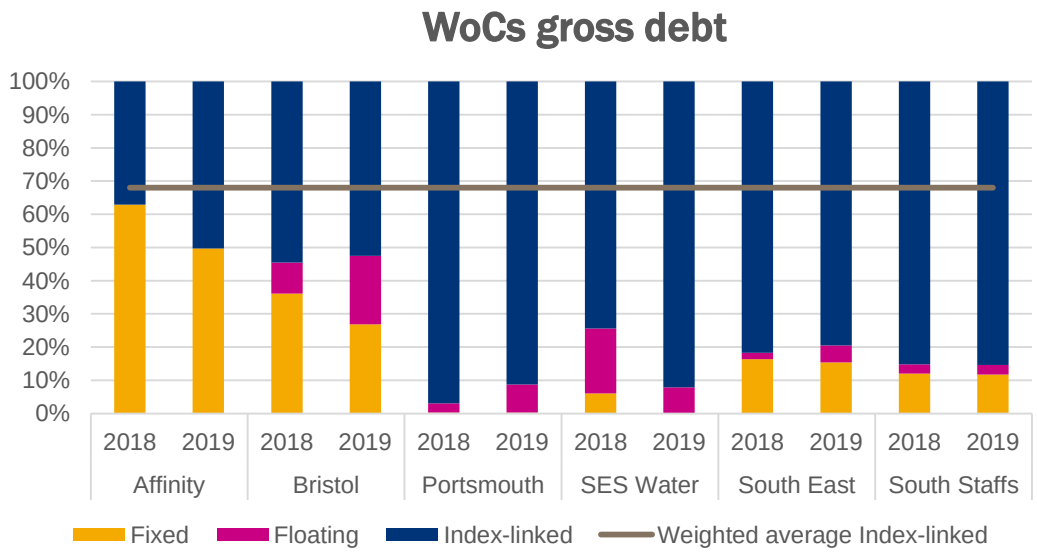
The average debt term across the sector at 31 March 2019 has reduced slightly to 13.8 years compared to 15.1 years in 2018.

Hafren's weighted average years to maturity and the composition of its debt has been impacted by restructuring of their debt finance in the year. Hafren's debt funding is all provided by Seven Trent, therefore it has no need to go to external markets to raise funds.



Composition of company borrowings





Companies typically use index linked debt to manage their exposure to inflation risk.

The use of index linked debt impacts the cash interest payments required each year. This can improve short term financeability but does not impact on companies' overall levels of debt.

At PR14 we assumed 33% of companies' net debt was index linked (linked to RPI).

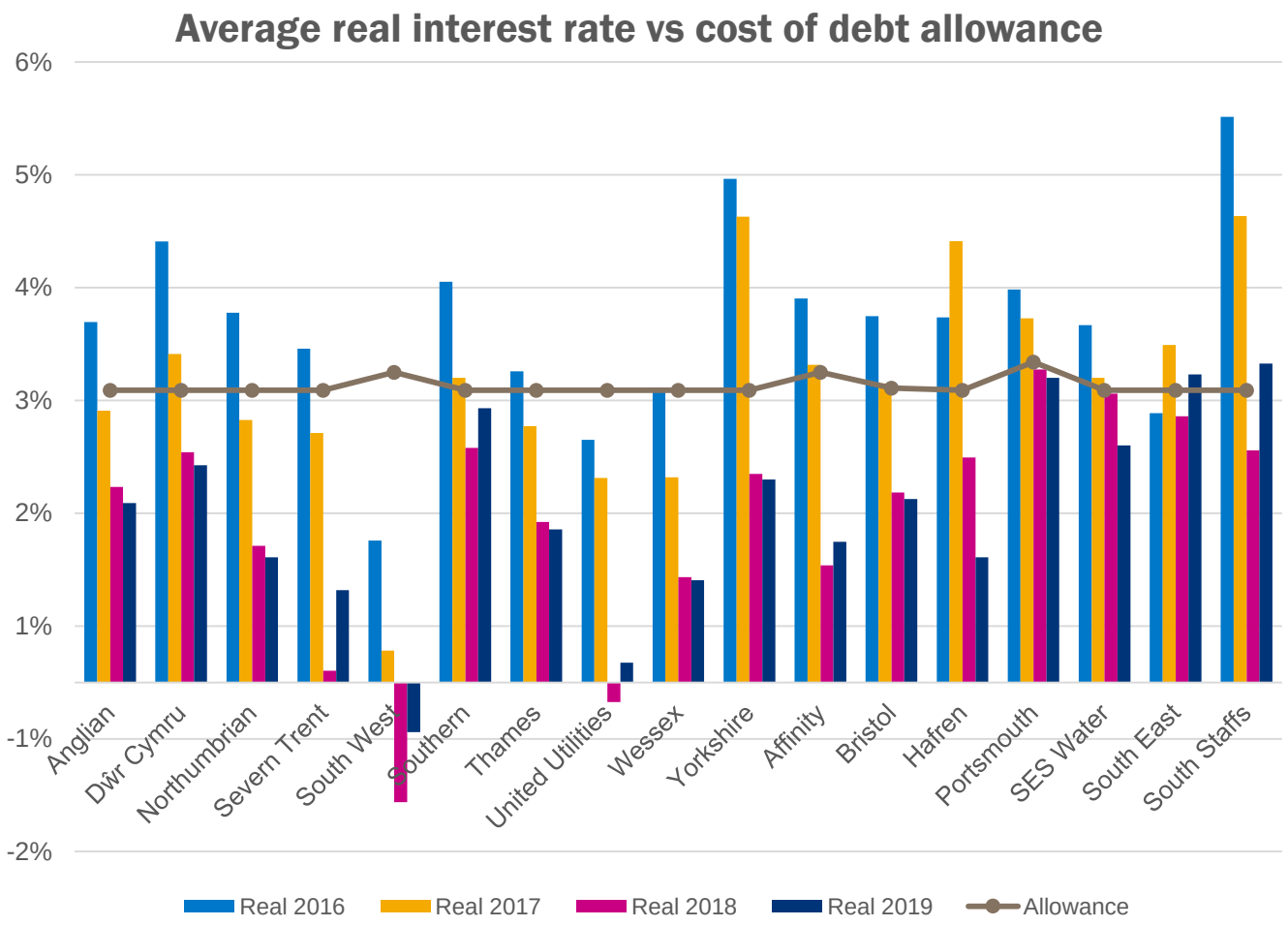
For WaSCs, in 2019 an average of 44% of debt was index linked, compared to 47% in 2018. For WoCs, in 2019 an average of 75% of debt was index linked, compared to 72% in 2018.

Historically, index linked instruments have been linked to RPI. However, with price controls transitioning from RPI to CPIH from 2020, some companies have issued CPI linked debt.

Companies that have issued CPI linked debt include United Utilities, Thames Water, Tideway and Affinity Water. Anglian Water have also added a CPI linked swap.

The charts show the gross debt of each company. Net debt (gross debt less cash) is used when calculating companies' regulatory gearing.

Cost of debt



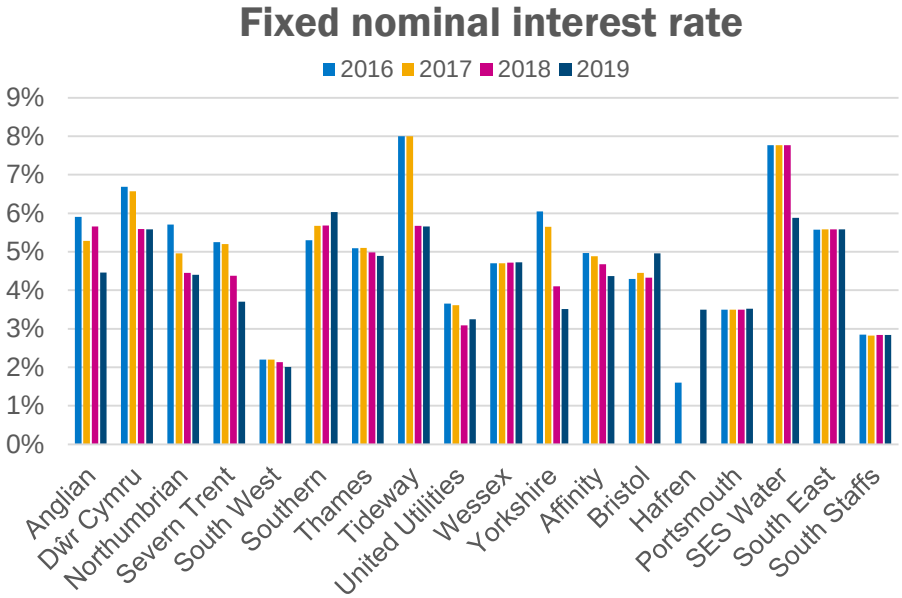
This chart presents the reported interest rates in real terms.

Where companies pay interest rates in nominal terms, changes in inflation levels will impact on the real interest rate that they incur.

As can be seen in the chart, two companies had negative average real interest rates in 2018, and one company had a negative average real interest rate in 2019 .

The PR14 cost of debt allowance was set in real terms. In order to allow comparison against the PR14 cost of debt allowance we have presented companies average nominal interest rates in real terms. To calculate this we have deflated the average nominal interest rates reported by companies by outturn average RPI, and presented these average real interest rates in the chart above alongside the PR14 cost of debt allowance.

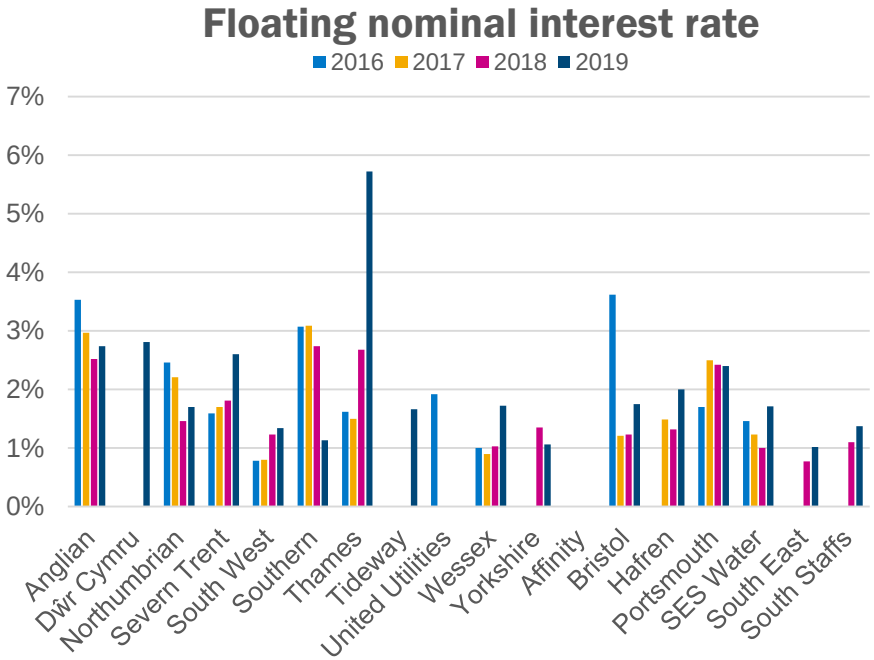
Reported interest rates

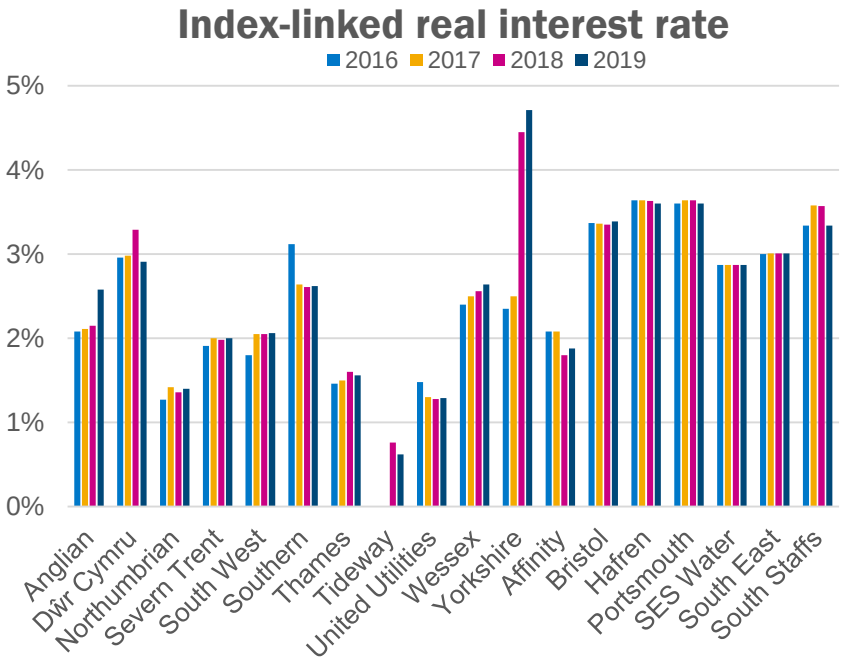


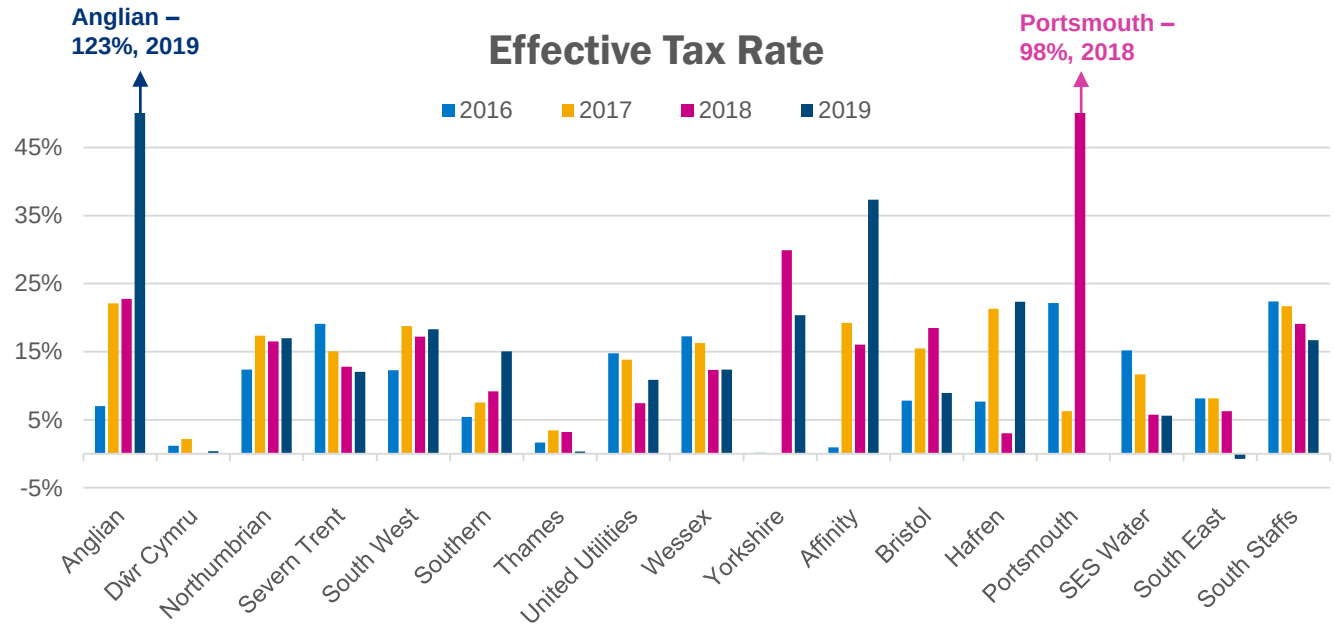
Companies have also published details of the interest rates paid in respect of their fixed, floating and index-linked debt in the year.

These charts present the average reported nominal interest rates paid in respect of fixed rate debt and floating rate debt, and the average real interest paid in respect of index linked debt.

As seen within the composition of company borrowings, floating debt makes up a relatively small proportion of most companies gross debt.







The effective rate of tax that companies pay is influenced by many factors including the level of capital expenditure over recent years, as a result of which they can claim capital allowances which reduce taxable profits

Dŵr Cymru, Thames and Portsmouth had an effective tax rate of zero in 2019.

Anglian's effective tax rate in 2019 has been impacted by two factors: a reduction in profit before tax and fair value adjustments in 2019 compared to 2018 due to intra-group interest no longer being received (the related intra-group loan was repaid on 29 March 2018), and the impact of a transitional adjustment arising on the adoption of IFRS15.

Affinity's effective tax rate in 2019 was impacted by two factors compared to 2018: a reduction in profit before tax and fair value in 2019 due to an increase in operating costs, and the tax adjustment in respect of prior years in 2019 being significantly lower than in 2018.

Portsmouth's effective tax rate in 2018 was impacted by the removal of the Employee Benefit Trust resulting in exceptional staff costs, which reduced reported profit, amplifying the impact of tax adjustments on the companies effective tax rate.

The disclosures made by companies show that Southern and Thames were able to utilise group relief which they did not pay for at the standard rate of corporation tax; this enabled them to reduce the amount of tax paid. Our PR19 methodology assumes companies will pay full value for any group relief that they receive and, if they do not, we will claw back, at a future price review, a proportion of the tax allowance they have received equivalent to that unpaid for group relief.

The effective corporation tax rate that companies paid in the year is calculated as the current tax charge for the appointed business as a percentage of profit before tax and fair value adjustments for the appointed business.

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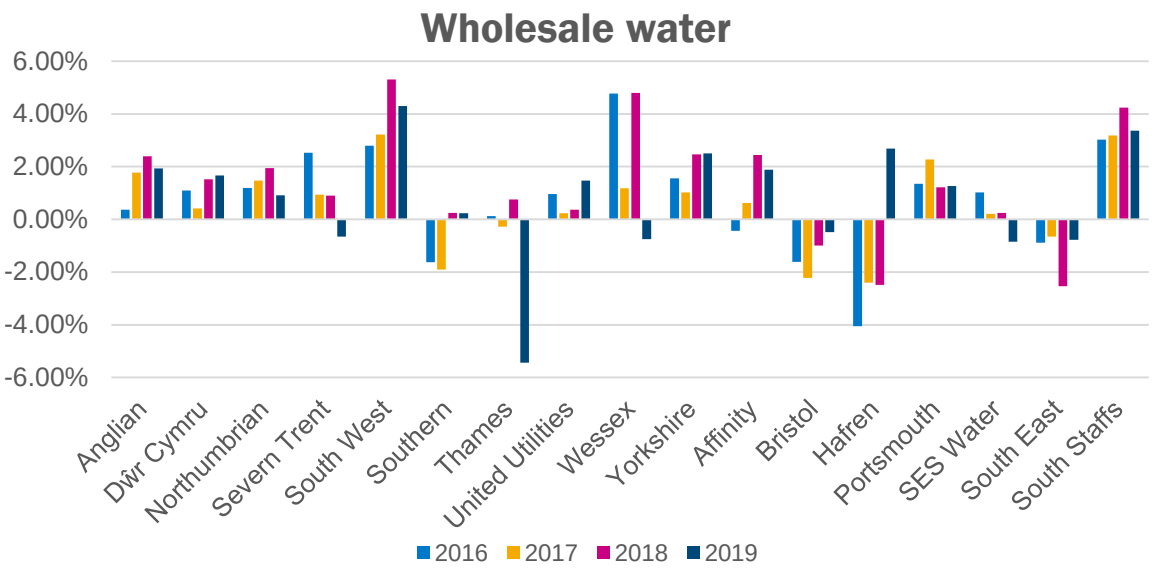
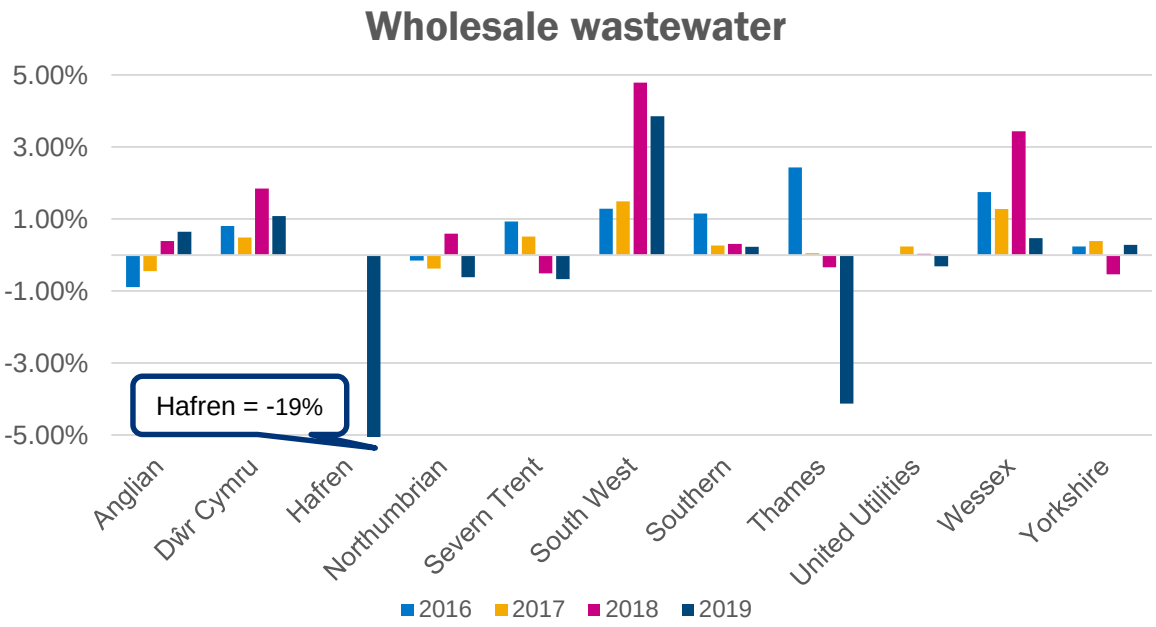
Wholesale revenue (under/over recovery)





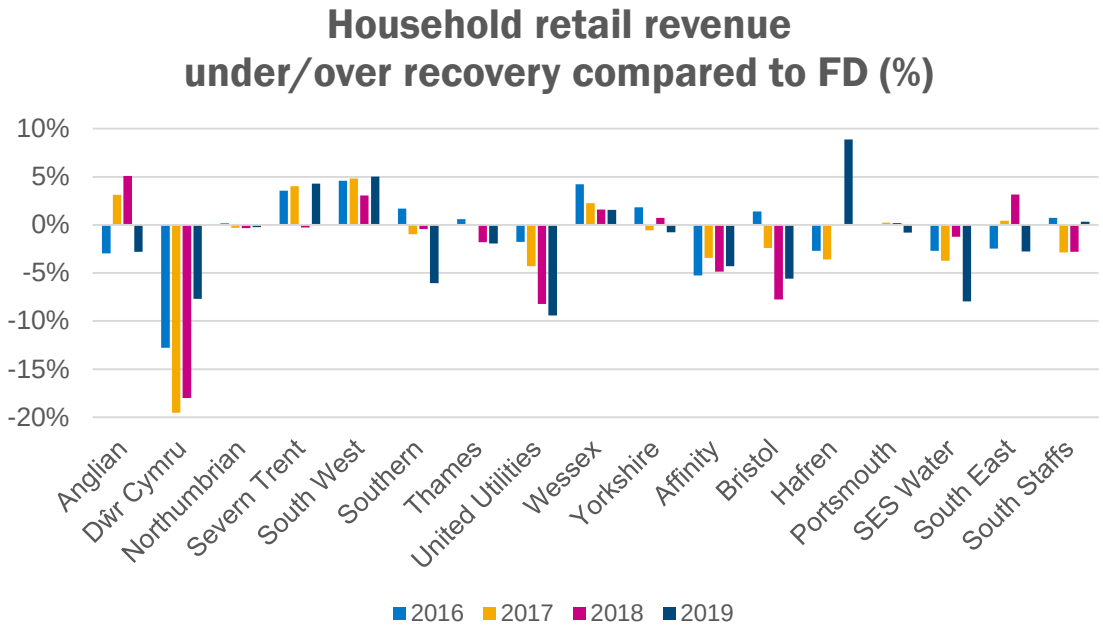
We set binding separate revenue controls for both water and wastewater.

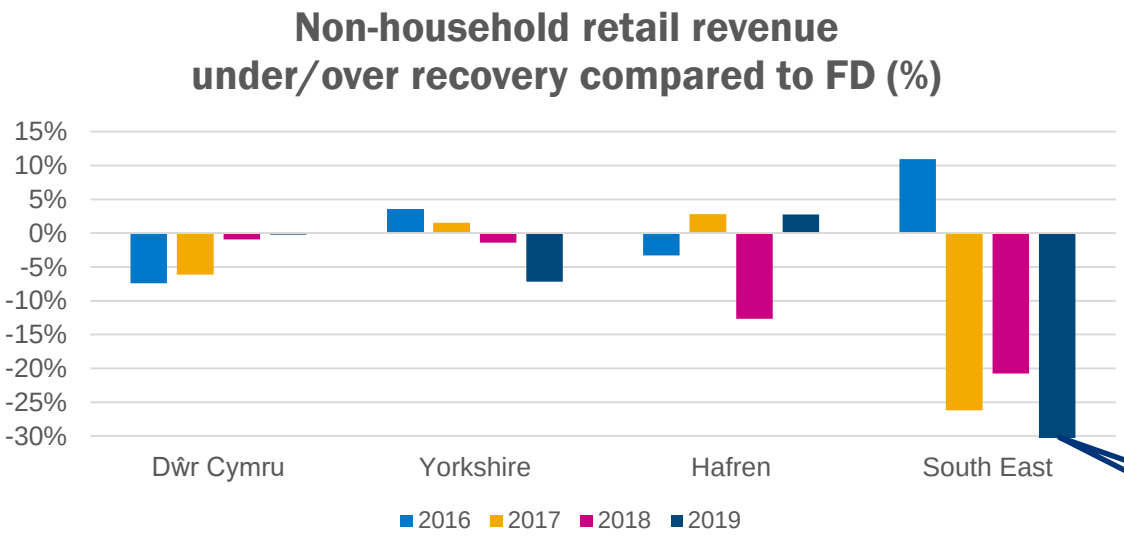
These charts compare revenue collected with revenue allowances. Companies are incentivised to accurately forecast revenue recovery under the wholesale revenue forecasting incentive mechanism (WRFIM), which allows reconciliation for over or under recovered revenue, subject to a penalty mechanism for material variances.

On the wholesale water side, Thames have under recovered by 5.4% of their allowance. Part of this is due to their package of commitments for poor operational performance, in which they agreed not to recover some revenue for their underperformance in leakage. The rest of this is due to core tariff adjustments due to lower than forecasted customers.

Hafren has started providing wastewater services for the first time as a result of their recent boundary changes. One of the consequences of this change is that the customers effected in this change would have had a significant increase in their wastewater bill. To avoid this bill increase and because this control only makes up around 11% of their total wholesale revenue, Hafren have intentionally under-recovered in the wastewater control.

Retail revenue (under/over recovery)





South East = -120%

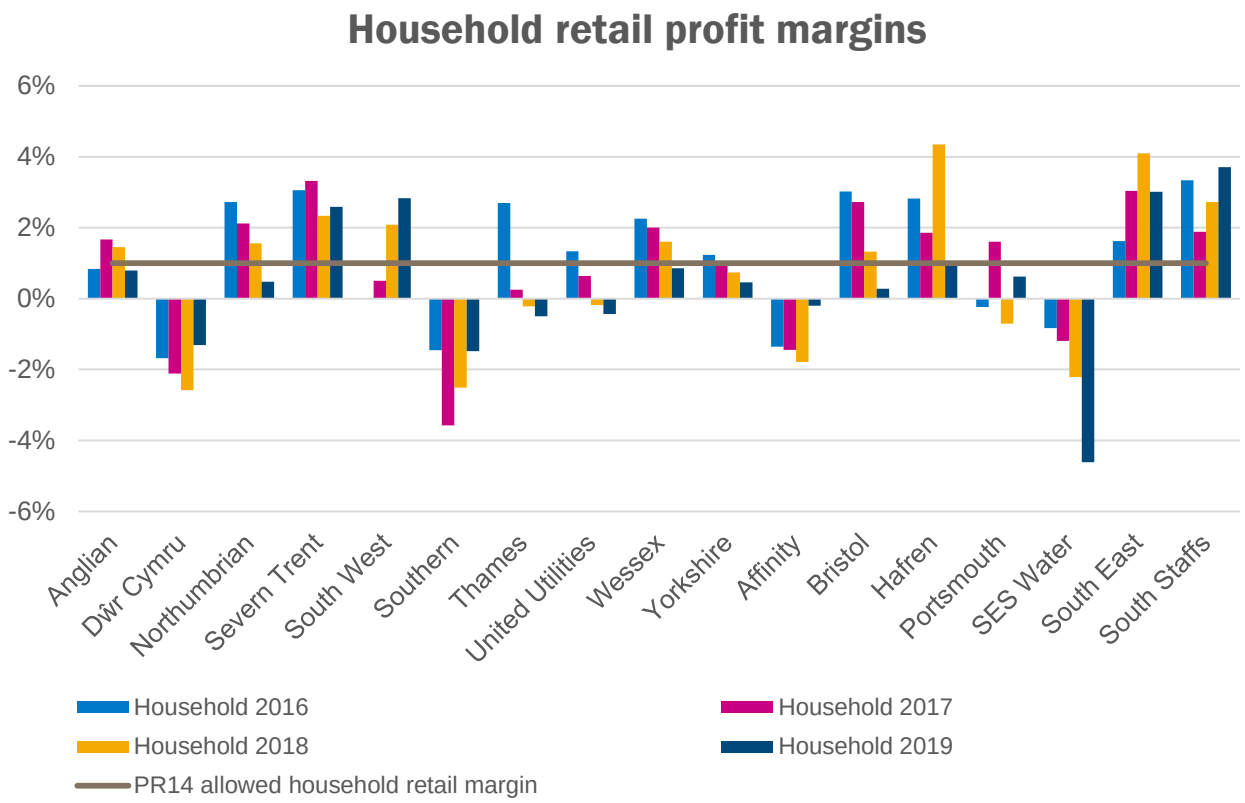
These charts show the household retail component of revenue and non-household retail component of revenue compared to the amounts forecast at the PR14 final determination. The household and non-household controls are separate.

The household revenue chart continues to show a substantive under recovery of revenue by Dŵr Cymru, in part due to the provision of affordability tariffs.

Additionally, two companies are showing large under recovery on household revenue. Both United Utilities Water (9%) and SES Water (8%) say that their under recovery is driven by an increased take up of social and support tariffs.

Following South East Water's exit from the NHH retail market, reimbursements for over-estimated meter reads and adjustments to prior leakage allowances have led to a negative revenue being reported against their 2018-19 FD NHH revenue. The reported revenue for this control was -£0.7m.

Household retail profit margins



Our PR14 determinations assumed a household retail margin of 1%.

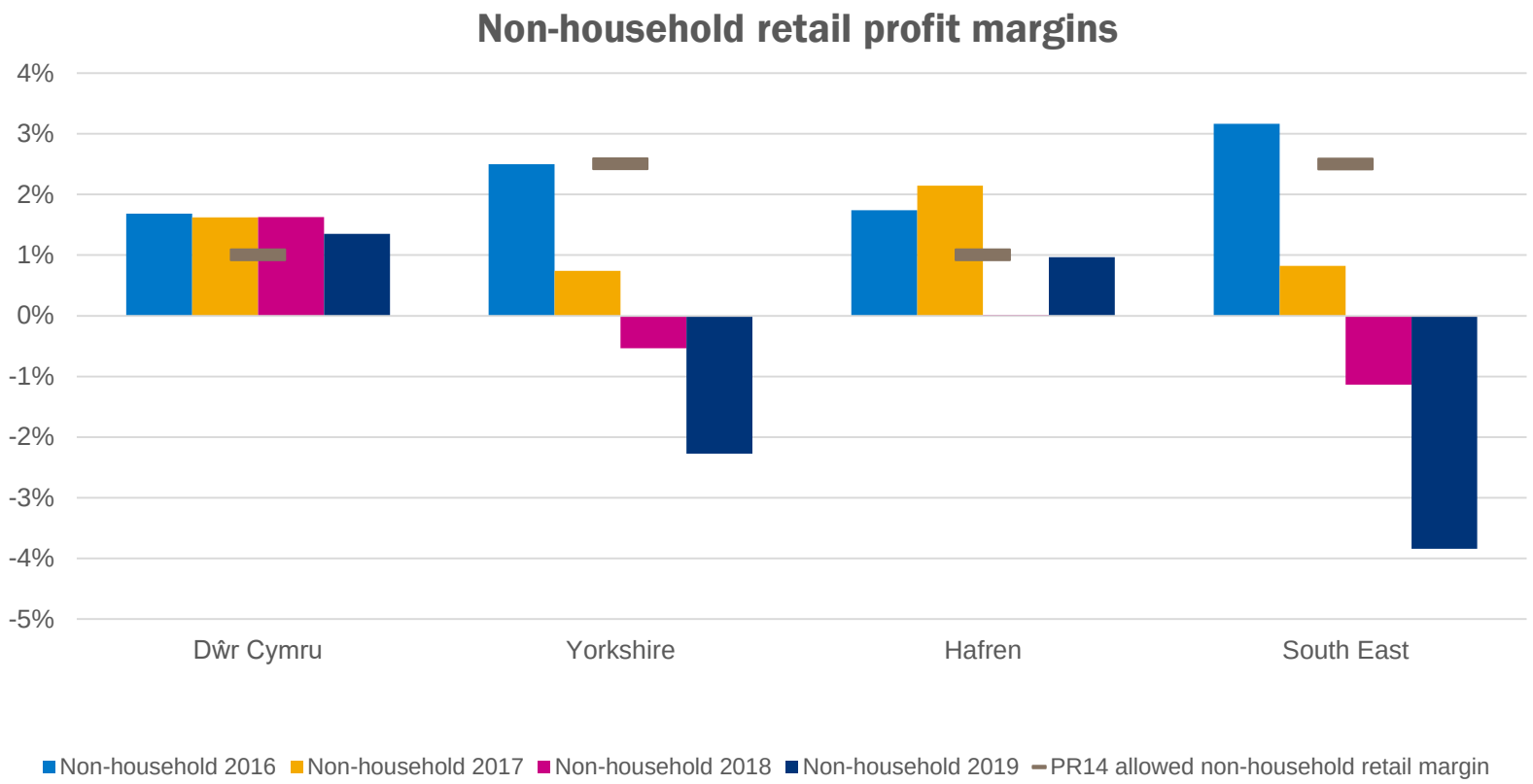
As stated in the retail revenue slide, SES Water recovered significantly less revenue than previously forecast. As a consequence of this, their household retail profit margin is lower.

Allowed margins were calculated by reference to the allowed costs at the FD. Companies' actual margins earned can vary from the amounts allowed in the final determination if their retail costs differ from the average cost to serve that we assumed in each companies' FD's. Companies can earn household margins above the levels allowed, by reducing costs below the levels allowed in the final determinations and by managing bad debts, but must bear the costs if their costs rise above the allowance.

The household and non household controls are separate binding controls and costs (and revenues) must be allocated to the control to which they relate.

Further information about each company's performance can be found in their APRs, which each company publishes on its website.

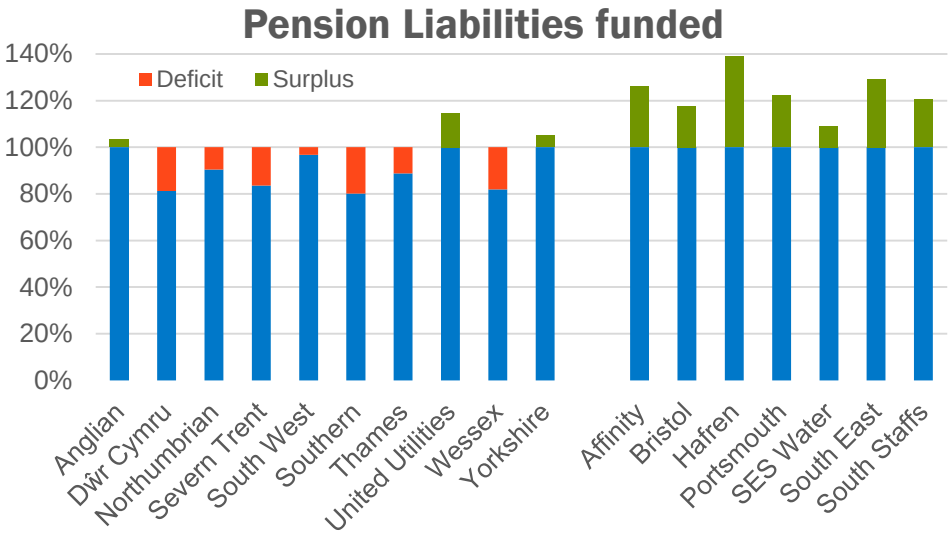
Non-household retail profit margins



The graph above shows the non-household retail profit margins for all four of the major water and wastewater companies that participated in the market this year. South East Water formally exited on 1 May 2018.

From 1 April 2017 the non-household retail market in England has been open to competition for eligible customers. This report only deals with the main providers of water and sewerage services, so does not report on any of the other retail market participants. As of October 2019, when Yorkshire became the final English company to exit the market, only the two companies operating wholly or mainly in Wales , Dŵr Cymru and Hafren, have a non-household retail component to their business.

Pension liabilities



Note: Pension deficits (red) / surpluses (green) as a percentage of total pension liability as reported in the 2018-19 statutory accounts.

Overall the industry wide deficit at March 2019 equalled an average of 3.4% of total pension liabilities compared to 4.1% at March 2018. This 0.7% improvement, which equates to £60 million, appears to result from a mix of reductions in discount rates and assumed inflation rates offset by higher asset values and a small reduction in average mortality assumptions.

Anglian Water, United Utilities Water, Yorkshire Water and all of the water only companies continue to report a surplus. All other water and sewerage companies report a deficit. Severn Trent has, again, the largest deficit, as a percentage of RCV, at 5.1% although down from 6.3% in 2017-18. The chart shows deficits and surpluses as a percentage of total pension liabilities by company.

Each company determines its own assumptions, including discount and inflation rates. All of the water and sewerage companies do however publish sensitivities which are useful in observing potential liability volatility. For example, a 50-basis point decrease in discount rates could equate to a increase in overall liabilities of circa £1.2bn.

Cash contributions agreed by companies to repair deficits reflect actuarial valuations undertaken by independent scheme trustees and are reviewed and may be challenged by the Pensions Regulator. The results of actuarial triennial valuations may differ from accounting valuations as trustees are required to be prudent in setting assumptions. We expect companies to take account of their pensions position in their Long Term Viability Statements. Also when determining their dividend policy we expect companies' to take fair account of employee interests including pension deficits.

At the PR14 price review we set out our treatment of pension deficit repair costs for the 2015-20 price control period and beyond. We stated for each company the date at which customer contributions to deficit repairs will end; that no further allowances for deficit repair costs beyond the stated date will be allowed; and that we do not intend to allow within the PR19 price review companies to recover from customers any incremental deficit repair costs beyond those assumed at PR14 (which were based on PR09 valuations).

We continue to expect deficit repair costs, whether incremental or due after the dates specified, to be addressed by a company's management and/or contributed to by a company's shareholders.

Overview of Financial Flows

The 2019 Annual Performance Reports required companies to formally report information on their financial flows for the first time, with 2018 being reported on a shadow run basis. The purpose of reporting on financial flows is to provide greater transparency and clarity about the financial returns to the company's equity holders each year. Financial flows information allows clear comparison between the financial flows under actual capital structures that companies have adopted and the structure we have used in setting the prices that customers pay. This is particularly notable where companies have adopted a complex highly-leveraged structure.

The Financial Flows metric looks at the returns that equity holders achieve. It compares the RoRE on two bases against the capital structure and returns assumed by Ofwat at the last price review in 2014.

1. The actual returns that companies earned based on Ofwat's assumed capital structure.
2. The actual returns that companies earned on their actual capital structure.

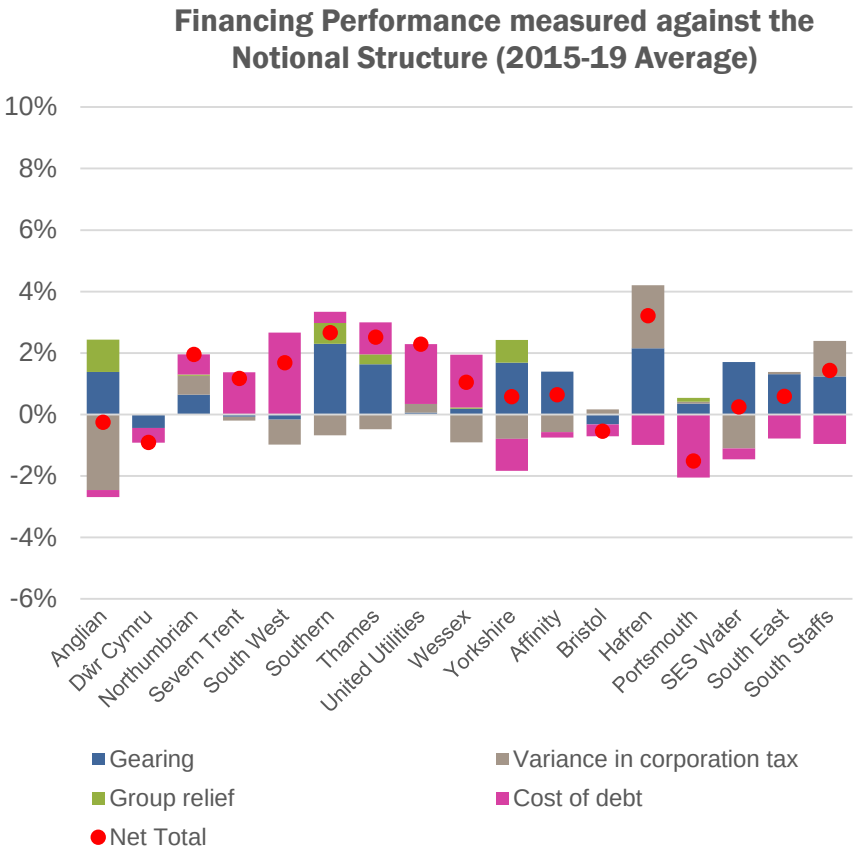
The metric starts with the base RoRE assumed in price limits set in 2014 adjusted for true ups for incentives in previous price reviews. Changes in RoRE are then analysed into changes due to (i) financing over/underperformance and (ii) operational over/underperformance. Inflation is then added to create the total shareholder return.

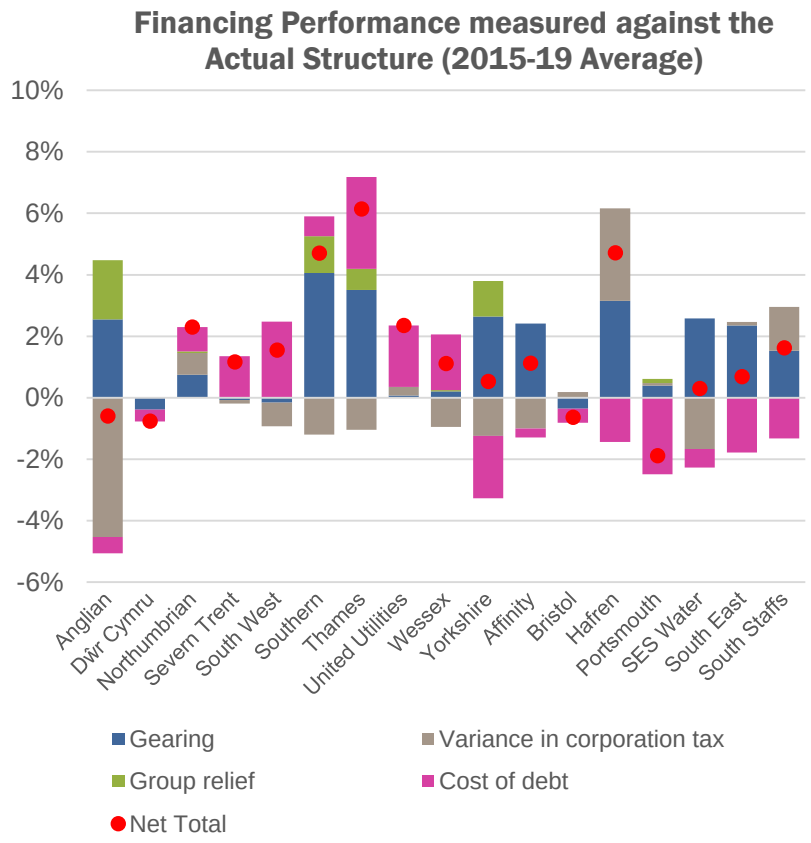
There are slight differences between some of the component parts of RoRE and the comparable component parts used in financial flows (reported on pages 24 and 25). This is a result of differences in the underlying calculations, e.g. the treatment of corporation tax and the building blocks of interest.

As part of the reporting requirement companies are also required to provide supporting narrative to explain the data contained in the table. This narrative needs to be such that the reader can interpret and understand the data within the table. We have seen some improvements in the quality of the company's supporting narrative from the previous year.

Going forward we expect companies to refine and better articulate this supporting narrative to aid the readers understanding of the information.

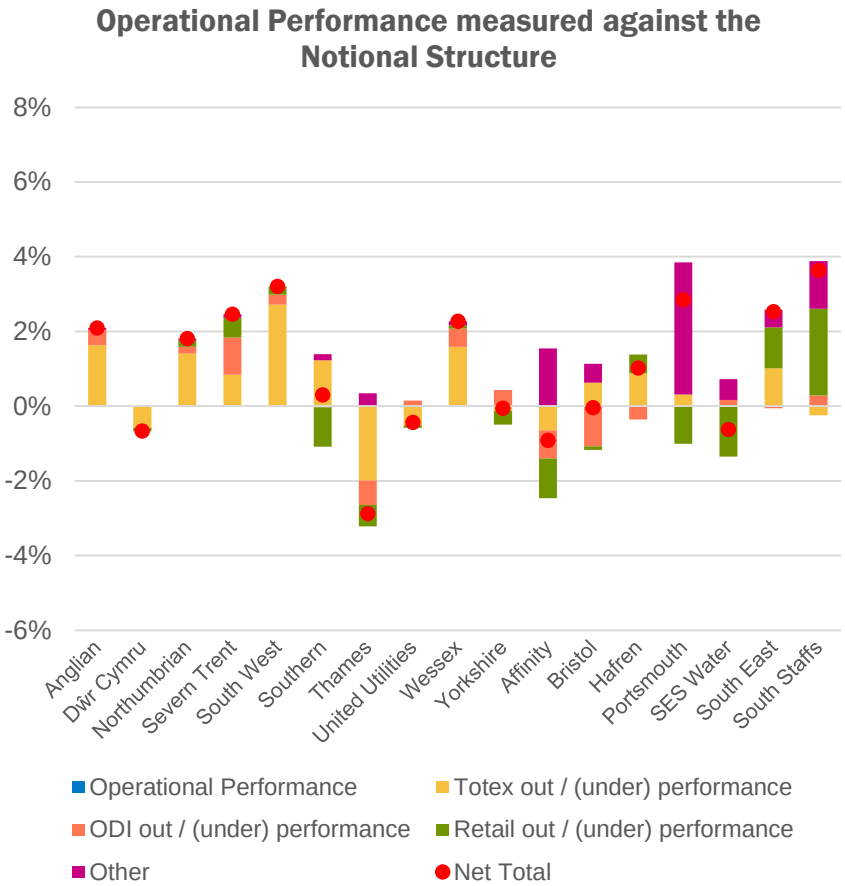
Financial - Out/Under Performance – 2015-19 average

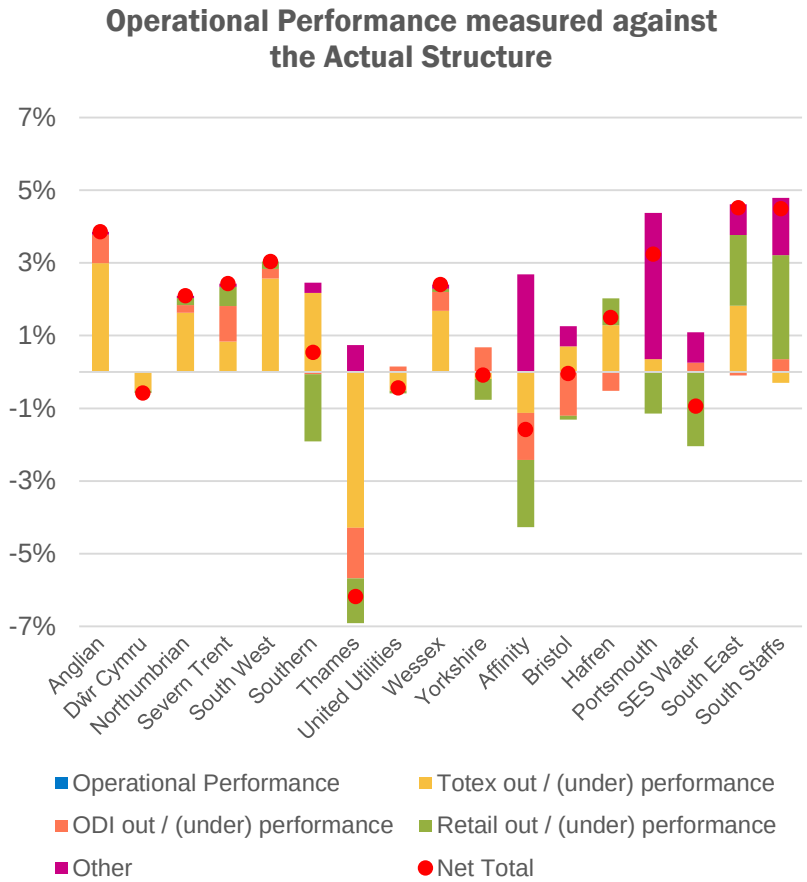




The table above shows the actual financial performance against the notional structure (62.5% gearing) and the company's actual financial structure. Company's that have adopted a financial structure different to the notional structure will demonstrate amplified under and outperformance in comparison with company's that have adopted an actual gearing structure closer to the notional.

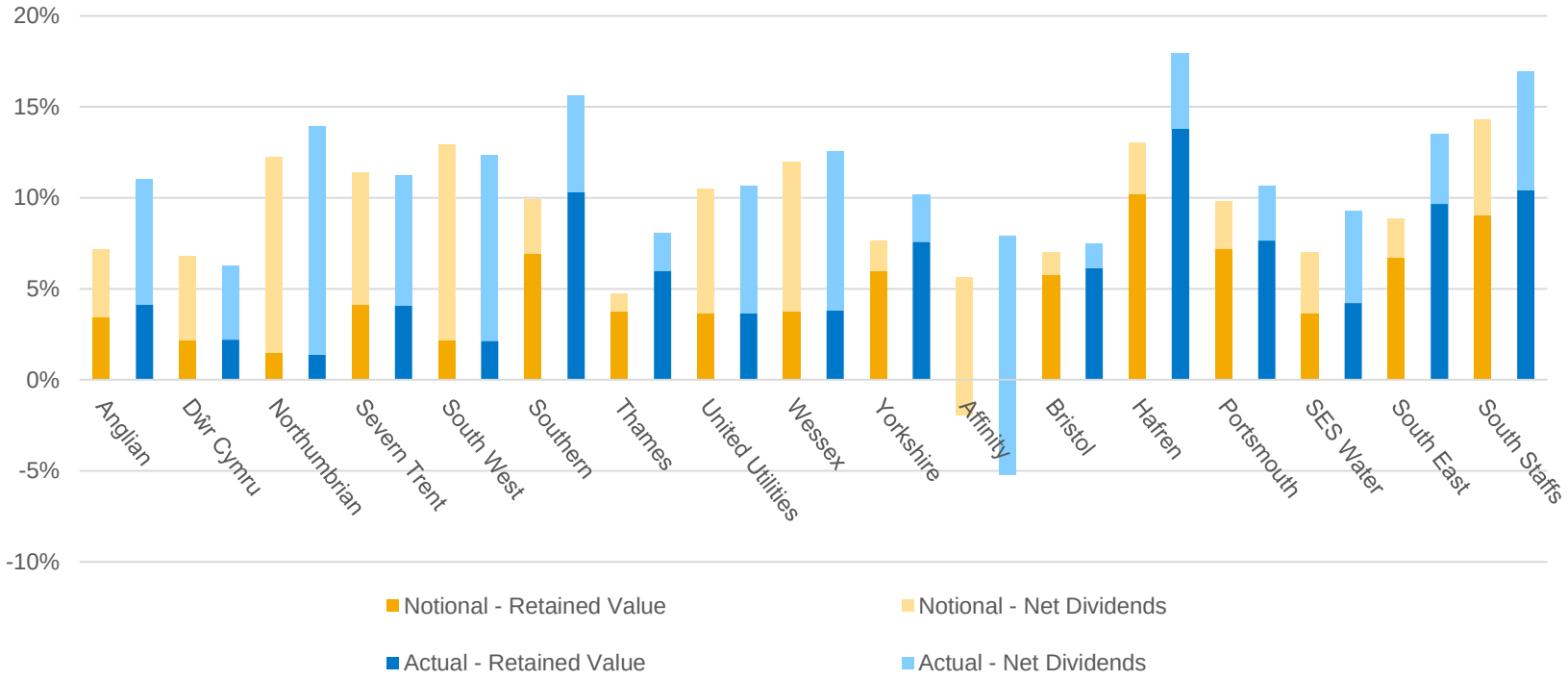
Operational - Out/Under Performance – 2015-19 average





The table above shows the actual operation performance against the notional structure (62.5% gearing) and the company's actual financial structure. Company's that have adopted a financial structure different to the notional structure will demonstrate amplified under and outperformance in comparison with company's that have adopted an actual gearing structure closer to the notional.

Total Shareholder Return – 2015-2019 Average



The Total Shareholder Return, shown by the full length of the bar in the chart above, represents the value attributable to the company shareholders' for the reporting period before the distribution of any dividends. This is calculated with reference to both the notional and actual regulatory equity. The value attributable is built up from a base return set at PR14, an inflation amount and any out or underperformance for operational and financial activities.

The graph demonstrates the net dividends paid as a proportion of Total Shareholder Return. Affinity's bars sit below 0% in the graph which reflects that its average 2015-2019 net dividend was greater than its average 2015-2019 Total Shareholder Return.

Net dividend is the total appointee dividend less the total amount of interest income received on intra-group loans as included in the P&L Account.
Retained value is Total Shareholder Return minus net dividend.

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Appendix 1: Glossary

APR	Annual Performance Report – Annual report of performance published by the appointed companies
FFO	Funds from operations – calculated as cash generated from operating activities adjusted to remove changes in working capital, less net interest paid and tax paid
FD – Final determination	The final determination of allowed costs, revenues and prices by Ofwat
Gearing	Net debt / RCV
Net Debt	Net debt is calculated as all borrowings of the company less cash. It excludes any pension deficit liability and mark-to-market accounting adjustments
Nominal	Interest rates, prices and costs are said to be in nominal terms if they include the impact of inflation
Notional	Ofwat "notional" capital structure for setting prices. For the current period the notional gearing is 62.5%
PR14	The Price Review which covers the period 2015-2020
PR19	The Price Review which covers the period 2020-2025
RAGs	Regulatory Accounting Guidelines
Real	Interest rates, prices and costs are said to be in real terms if they exclude the impact of inflation
Regulatory deprecation	The amount by which the RCV is depreciated
RCF	Retained Cash Flow – FFO less equity dividend paid
RCV	Regulatory capital value – this is the regulatory value of the investment that has been made in the company
Regulatory Equity	RCV less net debt. This can be in actual or notional terms
RORE	Return on Regulatory Equity – a return metric calculated using the notional level of net debt
Securitisation	Securitisation enables a company to raise debt by granting a mortgage (charge) over an identifiable stream of future cashflows
Totex	Total expenditure which includes both operational expenditure (opex) and capital expenditure (capex)
WaSC	Water and wastewater companies
WoC	Water only companies

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Appendix 2: Company Glossary

Water and sewerage companies

Anglian	Anglian Water Services Limited
Affinity	Affinity Water Limited
Bristol	Bristol Water plc
Hafren	Hafren Dyfrdwy Cyfyngedig (previously Dee Valley Water Limited)
Northumbrian	Northumbrian Water Limited
Portsmouth	Portsmouth Water Limited
Severn Trent	Severn Trent Water Limited
South Staffs	South Staffordshire Water Plc
South West	South West Water Limited
South East	South East Water Limited
Southern	Southern Water Services Limited
SES Water	Sutton and East Surrey Water plc (trading as SES Water)
Thames	Thames Water Utilities Limited
Tideway	Bazalgette Tunnel Limited
United Utilities	United Utilities Water Limited
Dŵr Cymru	Dŵr Cymru Cyfyngedig
Wessex	Wessex Water Services Limited
Yorkshire	Yorkshire Water Services Limited

Credit Rating Agencies

Moody's	Moody's Investors Service
S&P	S&P Global Ratings
Fitch	Fitch Ratings

Appendix 3: Comparability of data

To enable us to make meaningful comparisons between companies it is essential that the information about each company is compiled on a consistent basis.

We have been working with companies to ensure that all companies are reporting data that is clear and transparent and that they are reporting in line with guidance that we have issued.

We are continuing to keep our reporting guidance under review and continue to highlight examples of good practice in reporting. We will also issue further guidance and clarification where we consider it necessary and will look to incorporate this into the Regulatory Accounting Guidelines (RAGs).

We also recognise that there may be good reasons why companies may wish to present alternative versions of specific metrics which we have asked them to publish. In this case we have asked companies to make it clear that they are using an alternative approach and to clearly state how their alternative calculations differ from the approach specified for the APR.

We do not expect any one company to be identical to all other companies. However we believe that, where appropriate, a company should be able to explain its relative position compared to its peers.

Where appropriate we have included the financial results of Bazalgette Tunnel Limited (Tideway) which is currently constructing the Thames Tideway Tunnel. While Tideway is a regulated business, its activities are significantly different to those of the other regulated water and wastewater companies and as a result we do not expect its financial performance to be directly comparable with that of the other regulated companies.

End notes (1)

1. While we have undertaken a high level review of the information published by companies which has been included in this report to ensure consistency, the responsibility for the accuracy of the information that each company publishes and which we have used when compiling the report remains with each of the appointed companies.

Where companies have restated figures and / or revised their 2018-19 APRs prior to our publication of this report, we have updated this report in line with the revisions made by companies. If companies were to restate figures and / or revise their 2018-19 APRs following the publication of this report these changes will not be reflected in this report.

2. Severn Trent Water acquired Dee Valley Water in 2017. Variations and modifications to the Conditions of Appointment (licences) for both companies were made, effective 1 July 2018. The related boundary changes allowed Hafren Dyfrdwy (formerly Dee Valley Water) to become a water and wastewater services company based wholly in Wales and for Severn Trent Water to become a water and wastewater services company based wholly in England.

For ease of reference, this report refers to Severn Trent and Hafren for all years. The historic data for these companies has not been adjusted, therefore the data prior to 01 July 2018 is not reflective of the boundary changes, and prior to 2017 is not reflective of the acquisition.

As a result of these variations there has been a reallocation of allowed revenue and RCV between the two companies. The impact on Hafren was a reduction in RCV of around 27% and an increase in allowed revenue and costs. The impact of these changes is that the base RORE that Hafren is able to earn financial year ended 31 March 2019 has increased to 6.9% (average 6.5% for 2015-20) compared to the base RORE of 5.8% (average 5.8% for 2015-20) assumed in the PR14 final determination. The impact on Severn Trent was an equivalent increase in RCV and reduction in allowed revenues. Due to the relative sizes of the two organisations the impact on the base RORE of Severn Trent is less significant. Overall there have been no changes to the total allowed revenue the two companies are able to collect, or increase in the total returns the combined businesses are able to earn, within the 2015-20 period.

Due to the boundary changes, Hafren's region is now more rural. The very low population density of their new supply area has driven up the asset and operating complexity of their network and therefore in turn driven up the cost of operating and maintaining their network. However, in line with the commitments made when Severn Trent acquired Dee Valley Water and when the boundary changes were proposed, Hafren's customer bills were not increased as a result of these increased costs therefore Hafren's revenue has not increase in line with their costs.

3. Most companies' licences include a requirement with respect to maintaining an investment grade credit rating. The licences for South West and Hafren also contain this requirement however their licence allows for them to seek our agreement to exempt them from the requirement and to produce a credit rating certificate in place of the requirement. This is why no rating is shown in 2019 for Hafren and no rating is shown in any year for South West in the chart on the Credit Rating slide. South West and Hafren's licences do however require them to maintain financial metrics appropriate to an investment grade credit rating regardless of this.

Credit ratings are usually provided by one of the three main credit rating agencies. The minimum investment grade credit ratings are Baa3 for Moody's Investors Service and BBB- for both S&P Global Ratings and Fitch Ratings as shown by the red line. Where a company has received an appropriate credit rating from more than one agency, the lowest credit rating received has been recorded.

4. In July 2018 we published our Putting the sector in balance: position statement on PR19 business plans. Within this position statement we stated that companies with gearing levels materially above our notional assumption, should propose, in their business plans, outperformance sharing mechanisms that allow customers to share in the returns equity investors achieve from high gearing.

5. Anglian presented its financial metrics up to 2018 excluding certain internal transactions. The internal transactions which it excluded comprised: intra-group loan interest income and the corresponding dividend it made to its parent undertaking to enable it to service this interest, and in 2018 also comprised a non-recurring dividend it made to its parent undertaking to enable it to settle the intra-group loan.

6. Dŵr Cymru's ultimate parent undertaking is Glas Cymru Holdings Cyfyngedig. As Glas Cymru Holdings Cyfyngedig is a company limited by guarantee, it has no shareholders. Dŵr Cymru's does not typically pay any dividends to its parent company, but where it does no monies are transferred out of the Glas Cymru group of companies and all financial surpluses are retained for the benefit of customers. Due to this, Dŵr Cymru's adjusted appointee dividend is deemed to be nil, therefore only a total dividend yield is presented in the dividend chart for Dŵr Cymru.