Monitoring Financial Resilience Report
Year ended 31 March 2021

Report updated 17 December 2021 - Amendments to slides 12, 30 and 31

Ofwat

Executive Summary

Content

Water companies provide an essential public service. To ensure they can carry out their statutory functions and efficiently finance the delivery of their obligations to customers now and in the long term, it is important that they remain financially resilient.

We require all water companies to publish information relevant to their financial performance and financial position in their Annual Performance Reports (APRs). Companies are responsible for the accurate reporting in their APRs; this report captures and presents financial data reported by companies for the year ending 31 March 2021 (2020-21).

For 2020-21, we trial a dashboard of key metrics alongside our overall messages on financial resilience. We also provide an overview of our assessment of companies' dividend policies and long term viability statements against our expectations.

All information in this report uses data submitted by companies, together with other publicly available information, including from statutory accounts and reports from the credit rating agencies. The supporting data underpinning the charts in this report has also been published on our website.

Companies performance on key components of outcome delivery and expenditure is considered in our service delivery report.

Key messages

This report provides insight into the financial resilience of the incumbent water companies in England and Wales*, and the level of resilience across the sector as a whole. As monopoly providers of an essential service, it is important that all water companies are resilient to changing economic and environmental conditions to ensure they remain able to provide an excellent service to their customers. A sector with strong long term financial resilience is more attractive for investors.

In 2020-21 companies have had to adapt to a challenging economic environment driven largely by, and responses to, the coronavirus pandemic (COVID-19), illustrating why it is important for companies to be financially resilient. Overall, companies have managed the disruption to their businesses well. The sector has remained attractive to investors, and we have seen companies continue to effectively raise finance and to invest in 2020-21 to support growth and the wider resilience agenda, funding total Net Totex of £9.5bn and sustaining regulatory capital (RCV) growth across the sector (of approximately 1.9%)**.

The strength of a company's financial resilience cannot be captured in a single measure. We consider a range of financial data alongside the outcome of our service delivery assessment, as without financial resilience, operational resilience can be put at risk and underperformance against performance commitments can have financial consequences.

For the first time this year we trial a dashboard of some of the more key financial metrics. The Dashboard orders companies by credit rating and then outlook as at 31 March 2021. Where credit rating and outlook are the same, companies have been ordered taking account of regulatory gearing and derivative exposure.

The Dashboard provides a useful snapshot indicative of the relative strength of each company's financial resilience, based on data as at 31 March 2021 and taking account of performance in the first year of the current price control. The Dashboard is not intended to be static, and we will consider how the Dashboard could be evolved for future reporting.

*The 17 largest companies.
**Wholesale Totex for the 12 months ended 31 March 2021 (APR, Table 2B). Total wholesale expenditure in the year (total operating expenditure plus total gross capital expenditure), after deducting for grants and contributions received. RCV growth is post the regulatory reconciliation adjustment made to the RCV at the start of the 2020-25 period to take account of performance in the 2015-20 review period.
Data excludes Tideway.

Key metric dashboard – at 31 March 2021

Company	Credit Rating and Outlook (A)	Regulatory Gearing (B)	Financial Derivatives / RCV (C)	Adjusted Interest Cover Ratio (D)	Funds From Operations / Net Debt (E)	Interest Rate (F)	RoRE (G)	Dividend Yield (H)	Service Delivery Categorisation (I)
Dŵr Cymru	3	60.2%	4.5%	0.91	0.07	3.1%	1.2%	0.0%	1
United Utilities	2	65.3%	-2.7%	2.29	0.11	2.1%	4.5%	0.0%	1
Severn Trent*	2	66.1%	0.6%	1.52	0.09	3.3%	5.6%	1.8%	2
Anglian*	2	82.7%	9.6%	1.19	0.06	3.9%	3.8%	0.0%	2
Portsmouth	2 (Neg)	70.3%	0.0%	1.54	0.08	4.6%	1.1%	2.2%	2
Affinity	2 (Neg)	77.1%	3.7%	0.74	0.04	3.2%	2.3%	0.0%	1
Northumbrian	2 (CW Neg)	69.5%	1.3%	0.97	0.07	3.8%	2.8%	0.0%	1
South Staffs	1	66.7%	0.6%	2.52	0.15	6.1%	-0.6%	3.5%	1
Wessex	1	69.9%	0.0%	1.81	0.08	3.1%	2.9%	5.0%	1
Bristol*	1	70.9%	0.0%	2.27	0.11	4.0%	3.1%	3.7%	0
South East	1	78.4%	0.0%	2.00	0.08	3.9%	-0.5%	48.2%	0
Thames	1	83.2%	7.0%	1.51	0.06	3.3%	2.8%	1.3%	0
SES Water	1 (Neg)	71.0%	0.0%	0.22	0.08	3.3%	0.6%	5.5%	0
Yorkshire	1 (Neg)	77.2%	30.2%	2.24	0.08	3.5%	1.8%	2.8%	1
Southern*	0	71.8%	28.0%	1.06	0.08	2.1%	-0.7%	0.1%	0
Companies with a dispensation from the licence requirement to maintain a credit rating									
Hafren	-**	45.5%	0.0%	1.27	0.15	4.9%	1.6%	0.0%	1
South West	-**	67.2%	0.6%	2.95	0.12	2.0%	6.6%	9.1%	1

*Companies subject to notable changes post year end, see slide 8 and Appendix 3 for more detail.

**Hafren and South West are shown separately due to a dispensation from the licence requirement to maintain an investment grade credit rating. As required by licence, both have certified that they would be able to maintain an investment grade credit rating at year end.

Bazalgette Tunnel Limited (Tideway), the infrastructure provider responsible for the delivery of the Thames Tideway Tunnel project, is not included in the Dashboard as its activities and the way in which it is regulated differs to the rest of the industry.

A. Number of notches that a company's lowest credit rating, monitored for licence purposes, sits above the minimum rating for investment grade; 0=Baa3/BBB-, 1=Baa2/BBB, 2=Baa1/BBB+, 3=A3/A-. Companies are ordered by rating then outlook at 31 March 2021, Neg=Negative outlook, CW Neg= Credit Watch Negative.
B. Calculated as the ratio of net debt (borrowings less cash) for the appointed business to its RCV (regulatory capital value) at 31 March 2021.
C. Total net financial derivatives (excluding other) at mark-to-market/fair value / RCV at 31 March 2021. Liability shown as a positive %. Where credit rating and outlook are the same, companies are ordered taking account of regulatory gearing and derivative exposure.
D. AICR, calculated as FFO adjusted for RCV run-off divided by cash interest paid, for 2020-21.
E. FFO (cash generated from operating activities adjusted to remove changes in working capital, less net interest and tax paid)/ Net debt, for 2020-21.
F. Interest rate payable on the company's debt (indicative weighted average, nominal) at 31 March 2021.
G. Return on regulatory equity in reference to the notional capital structure, for 2020-21.
H. Total dividend for 2020-21 / regulated equity at 31 March 2021.
I. Overall categorisation of service delivery (0=Lagging behind, 1=Average, 2=Sector Leading).

Key messages

Most companies maintain adequate levels of financial resilience, however the Dashboard highlights there is variation in the levels of financial resilience across the sector. The Dashboard highlights characteristics common to those companies with relatively stronger and weaker resilience and, we observe that those companies exhibiting lower financial resilience are also in our lowest performance categories for service delivery.

- **Credit Ratings and Financial Metrics:** We expect resilient companies to be able to maintain headroom in the investment grade category and we expect all companies to keep their long term financial resilience under review.

  Those companies with stronger levels of financial resilience include Dŵr Cymru, Severn Trent and United Utilities who reported financial metrics and performance that supported a year end credit rating well within the investment grade.

  Those companies more weakly positioned in the Dashboard, such as SES Water, Southern and Yorkshire, exhibit lower levels of financial resilience. At 31 March 2021, these companies had the lowest levels of headroom within the investment grade category and more leveraged positions particularly when taking into account derivative exposures. Some of these companies are also in our lowest service delivery category.

  Southern Water maintains the lowest credit rating in the sector and is one of the worst performing companies in our service delivery report. Following a managed change of ownership in September 2021, additional equity has since been injected into the company.

  In some instances, credit ratings have been withdrawn. This includes a credit rating maintained by Yorkshire which was withdrawn post 31 March 2021. Concerns can arise where a credit rating, that was being monitored for licence compliance purposes, is withdrawn without a clear rationale.

  In 2020-21 there have also been examples of companies taking action to strengthen the financial resilience of the regulated company including a material equity injection at Hafren, and South East's paydown of its intercompany loan. We also note that a number of companies chose not to pay dividends in 2020-21 for reasons including economic uncertainty and to support resilience.

Key messages

- **Explanation of dividend payments rationale:** We have previously set out our clear expectation that companies need to explain how dividend payments take account of performance in delivering obligations and commitments to customers. There is a clear loss of public trust if customers and wider stakeholders cannot see that connection. Those legitimate concerns are heightened where companies also show poor performance for customers and the environment. At a sector level, dividends paid in 2020-21 were lower than in prior years. However, our assessment found that overall, the majority of companies were not explaining things clearly enough and should do a lot more to show how the levels of dividends paid or declared reflect the levels of service delivered. It is extremely disappointing that few companies met our expectations.

- **Long term viability statements:** Companies are required to set out their long term viability statements in the information they report. Our assessment found that overall, companies are identifying and setting out the impacts of risks that have been identified. However, there remains notable variance in the detail provided. In some cases, scenarios and sensitivities applied and the testing outcomes are not clearly set out or sufficiently detailed. Given the particular challenges to meeting long term financial resilience, it is vital companies that have failed to satisfy our expectations seek to improve transparency.

We are actively engaging with all companies on these and other matters, and continue to encourage companies to consider the impact of their financing decisions on their long term financial resilience. The relationship between financial resilience and service delivery is a key issue for Ofwat; as customer service and/or the environment can suffer if a company with poor operational performance does not have the financial flexibility to turn around poor performance. We plan to publish a discussion paper on the issue of financial resilience in December 2021.

Post year end changes

This report reflects financial data for the year ended 31 March 2021. For some companies, there have been changes post year end that are material to an assessment of financial resilience. In summary these include:

Severn Trent: Before year end the company announced its intention to issue new ordinary shares to raise approximately £250 million for its Green Recovery schemes (c.4.3% of its existing share capital). The placing completed 19 May 2021 and was oversubscribed.

Bristol Water: On 2 June 2021, Pennon approved the acquisition of Bristol Water Holdings UK Limited, including its subsidiary Bristol Water plc, the regulated company. The acquisition is subject to a mandatory referral to the Competition and Markets Authority (CMA) under the special merger regime that applies in the water sector.

Anglian Water: In June 2021, Anglian Water announced a new financing structure which has resulted in a deleveraging of the regulated company, in exchange for additional indebtedness in its holding companies. As a consequence Anglian Water has seen a significant decrease in its net gearing and an upgrade in its credit ratings.

Southern Water: In August 2021, Macquarie Super Core Infrastructure Fund (a fund managed by Macquarie) confirmed its acquisition of a majority interest in Greensands Holdings Limited, the ultimate holding company of the regulated business. As part of the transaction, Macquarie confirmed it would contribute over £1 billion of equity to the group, of which £543 million was to be injected into the regulated company. In addition, Southern has taken steps to simplify its financial structure.

Supporting Detail

Index

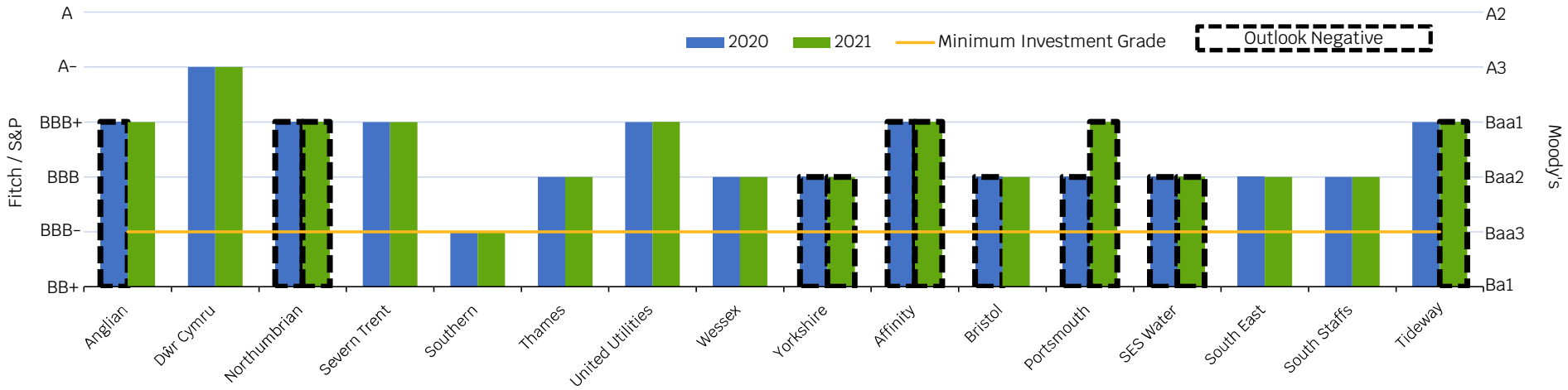
The supporting detail is structured as follows:

Section 1: Credit Ratings and Financial Metrics Analysis

17 December 2021
- Amendments made to the reporting of our assessment of South Staffs Water's dividend disclosures on slides 30 and 31.
- Amendment to slide 12 on the withdrawal of a Yorkshire Water credit rating previously maintained by Moody's.

Section 1 – Credit Ratings and Financial Metrics Analysis

Credit ratings – Lowest rating held for licence purposes at 31 March 2020 and 2021



As a condition of their licence, companies are required to maintain an investment grade credit rating*, with one or more of Moody's, S&P and Fitch. However, we expect companies to maintain headroom above the lowest of the investment grade category if they are able to maintain financial resilience and access the finance necessary to deliver services to customers.

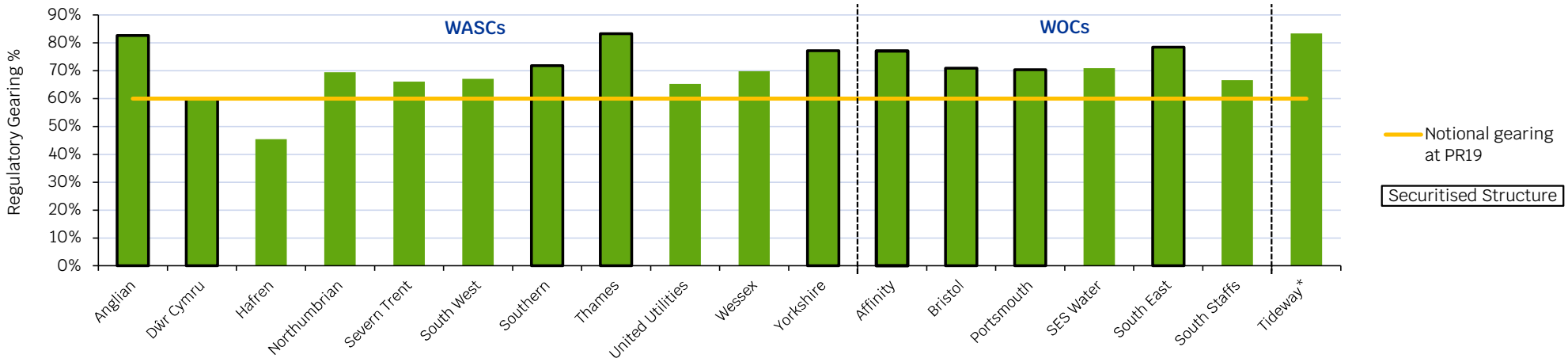
At PR19 most companies** indicated a target rating on their actual structure of BBB+/Baa1 being two notches above the minimum of investment grade. At 31 March 2021, eight companies held a credit rating for monitoring purposes at a level below that.

Southern maintains a credit rating that is at the lowest of the investment grade. As at 31 March 2021, SES Water and Yorkshire held credit ratings one notch higher than the lowest of the investment grade with negative outlooks. The negative outlook on SES Water has subsequently been removed. There have been a number of positive rating and outlook updates since the year end, which we set out at Appendix 3.

During 2020-21, Portsmouth and Wessex withdrew their credit ratings with S&P (BBB Negative and BBB Stable, respectively), Affinity withdrew its Fitch rating (BBB- Stable), and in May 2021 Yorkshire's corporate family rating maintained by Moody's was withdrawn (Baa2 Negative). The removal of a credit rating can result in the loss of information about a company's financial resilience that is important for regulatory purposes. Where relevant we engage with companies on these issues and we will consider the importance of credit ratings as markers of financial resilience in our forthcoming financial resilience discussion paper.

*As required under their licences South West and Hafren have certified they could maintain an investment grade issuer credit rating.
**PR19 final determinations: Aligning risk and return technical appendix

Regulatory gearing – At 31 March 2021



Regulatory gearing is the ratio of net debt to regulatory capital value (RCV). For 2020-25 notional gearing is set at 60%.

At the start of the review period a regulatory adjustment was made to companies opening RCV to reflect the outcome of our PR14 reconciliation process. For the majority of companies their RCV decreased, with a consequential increase in gearing compared to the position before the adjustment.

Total net debt for the sector at 31 March 2021 was £56.2bn, an increase of 1.1% compared to prior year end (£55.6bn).

At 31 March 2021 average gearing across the sector was 72.8% (31 March 2020, 71.7% pre and 73.3% post the PR14 reconciliation), with the water only companies (WOCs) more highly geared than the water and wastewater companies (WASCs) on average. Companies with a securitised capital structure also maintained typically higher levels of gearing at year end.

At PR19 the gearing outperformance sharing mechanism (GOSM) was introduced. The mechanism applies to all companies not subject to a PR19 redetermination by the CMA i.e. all companies except for Anglian, Bristol, Northumbrian and Yorkshire. For 2020-21, a threshold of 74% applies, beyond which customers share in the benefits of higher returns equity investors achieve from high gearing.

Hafren's gearing reduced during the year following the significant equity injection by Severn Trent and, after the year end Anglian's regulatory gearing decreased materially following a substantial equity injection into the company.

*In line with the RAGs, Tideway's shareholder loans (£720.4m at 31 March 2021) are included within the debt figure used to calculate gearing.
All sector references exclude the figures for Tideway.

Financial derivatives and other liabilities at 31 March 2021

Company	Regulatory Gearing (A)	Total Financial Derivatives as a % of RCV (B)	Retirement Benefit Obligation as a % of RCV (C)
Anglian	82.7%	9.6%	0.6%
Dŵr Cymru	60.2%	4.5%	1.5%
Hafren	45.5%	-	-
Northumbrian	69.5%	1.3%	3.0%
Severn Trent	66.1%	0.6%	3.7%
South West	67.2%	0.6%	-
Southern	71.8%	28.0%	2.3%
Thames	83.2%	7.0%	1.8%
United Utilities	65.3%	-	-
Wessex	69.9%	-	2.8%
Yorkshire	77.2%	30.2%	-
Affinity	77.1%	3.7%	-
Bristol	70.9%	-	-
Portsmouth	70.3%	-	-
SES Water	71.0%	-	0.4
South East	78.4%	-	0.2
South Staffs	66.7%	0.6%	-

A. Net Debt / RCV at 31 March 2021.
B. Financial derivatives are marked to market at the end of each reporting period and reported by companies in their statements of financial position at fair value. Total financial derivatives (excluding other financial derivatives) at mark-to-market/fair value (APR Tables 1C and 4I) / RCV at 31 March 2021. Excludes net asset positions.
C. Total retirement benefit obligation (APR Table 1C) / RCV at 31 March 2021. Excludes retirement benefit assets.

Companies may have wider potential liabilities than those captured by the definition of borrowings used to calculate regulatory gearing. As a consequence the regulatory gearing metric in isolation may not fully reflect a company's total potential liabilities at a point in time. These additional liabilities can impact financial resilience.

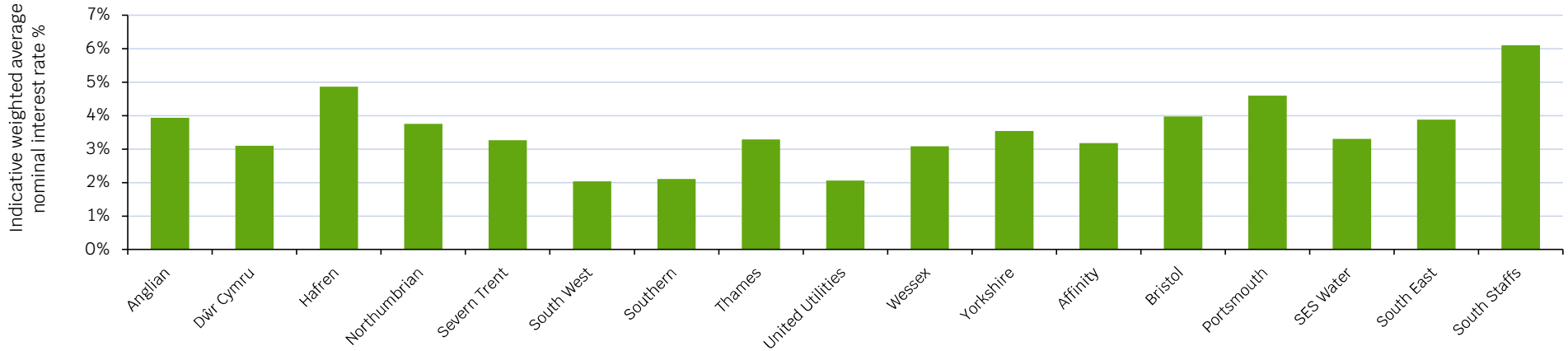
To illustrate this, we set out in the table the balance of companies' net mark-to-market liabilities arising from financial derivative arrangements and defined benefit (DB) pension obligations as a proportion of their RCV at 31 March 2021, alongside regulatory gearing. Neither mark-to-market liabilities nor pension deficit liabilities are included in the definition of net debt in calculating regulatory gearing.

Financial derivatives are used by companies to manage (hedge) namely inflation and interest risk. Depending on a range of internal and external factors companies' financial derivative portfolios can present an asset or liability. Material liabilities can impact on financial resilience as they can expose companies to sizeable mark-to-market losses (in a default scenario) and affect credit ratings. Moreover, where financial derivatives are used to alter cash profiles, including to bring forward interest receipts, this can affect financial ratios and mask underlying resilience issues.

Defined benefit pension schemes present long term financial obligations. Where material, deficits can have adverse impacts on a company's balance sheet and credit assessments and in particular drive increased cash demands on the company, and therefore can impact on financial stability.

Including such additional debt-like liabilities would have an impact on leveraged positions. For example, Southern and Yorkshire would both have a regulatory gearing above 100% at 31 March 2021 after including net financial derivatives and pension obligations on the balance sheet.

Cost of Debt – Nominal rates at 31 March 2021



At each price review we set an allowed revenue for companies which includes a return on capital. This is set to provide a reasonable base level of return reflective of the sector's risks, and which is sufficient to cover efficient debt and equity financing costs for a company adopting our notional financial structure.

Our allowed cost of debt for PR19 final determinations was projected to be 4.18% in nominal terms*, reflecting our assessment of the cost of debt to be raised in 2020-25 (new debt) and the cost of embedded debt, together with our long term inflation assumptions (CPIH 2.0% and RPI 3.0%). The allowed cost of debt differs between companies reflecting specific company adjustments and to reflect the CMA's decision for appealing companies. The allowed cost of new debt is subject to a reconciliation adjustment at PR24 to reflect changes in the market cost of debt.

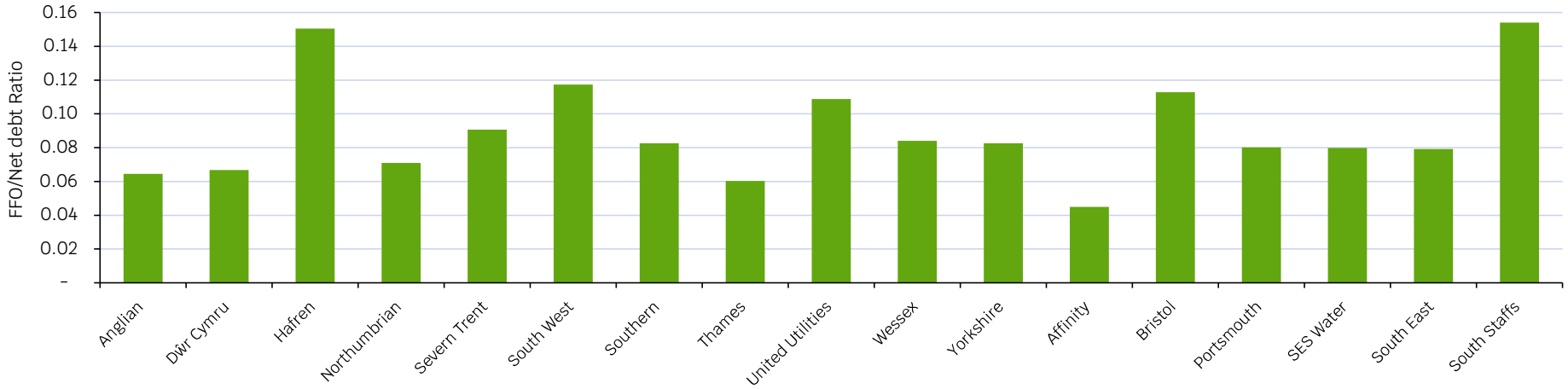
The chart presents the indicative weighted average nominal interest rate reported by each company. As outturn inflation for 2020-21 was significantly lower than our long term inflation assumption (CPIH 1.0% and RPI 1.5%**), companies' reported nominal rates for 2020-21 were generally lower than the nominal cost of debt allowance set for the price review period.

Nominal interest rates are reported post hedging arrangements. Excluding the effects of hedging, the underlying cost of debt for some companies would be higher.

South Staffs average rate is high compared to the rest of the sector due to a difference in reporting, with the company indexing their relevant debt by long term inflation rather than outturn.

*Weighted average using the ratio of new to embedded debt, PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf (ofwat.gov.uk)
**UK inflation data including CPIH and RPI, 12 months to 31 March 2021, Office for National Statistics

FFO to Net Debt – At 31 March 2021



This metric shows Funds From Operations* (FFO) being the net cash generated from operating activities each year available to service net debt.

FFO is stated after net cash interest paid and is reflective of a company's ability to deliver on its obligations within allowed revenues. FFO can be impacted by a range of factors including tax paid, pension cash contributions made, and this year companies' operations and their delivery against determinations has been impacted to varying extents by COVID-19.

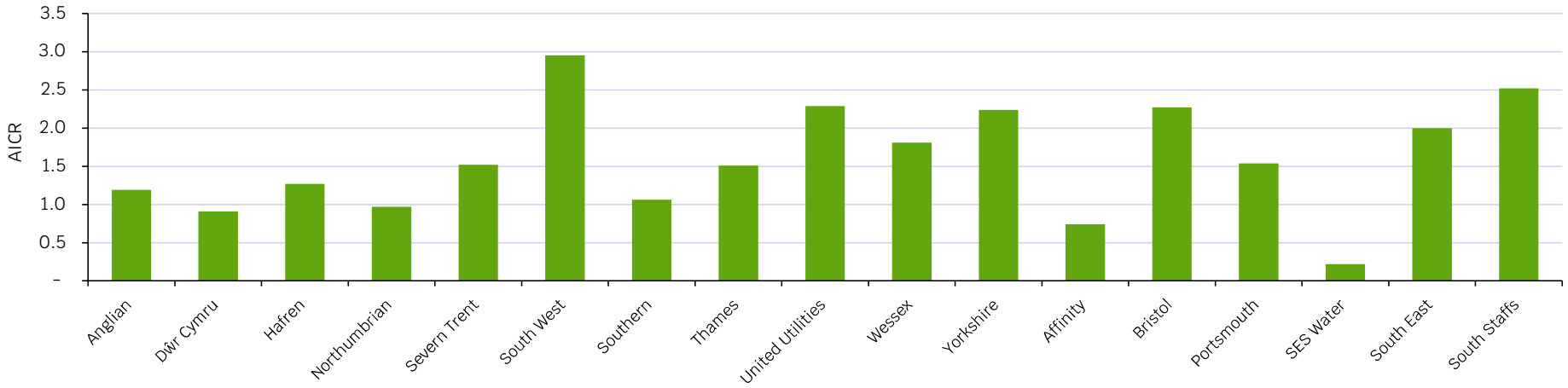
FFO also captures the impact of companies' financial derivative activities. In some cases companies have used financial derivatives to reprofile and reduce their cash interest payments/receipts which has improved FFO in the short term.

As noted, year end net debt across the sector has increased, but again there is variation.

Overall, the metric is driven by a range of factors some specific to the circumstances of each company and should be considered in the context of the operating environment and other corporate activities.

*Net cash generated from operating activities over 2020-21, adjusted to remove changes in working capital.

Adjusted Interest Cover Ratio – At 31 March 2021



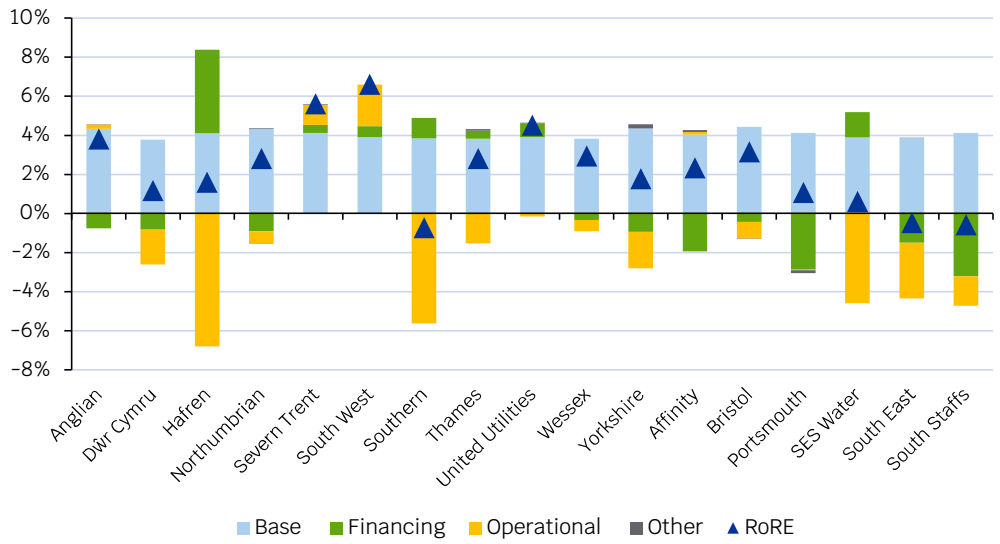
The AICR ratio measures the FFO available to meet interest paid, adjusting for regulatory depreciation ('RCV run-off') i.e. it represents the number of times that interest payable each year can be met from FFO.

The ratio is calculated by reference to cash interest paid in the period, and does not include inflation accretion on index-linked borrowings.

For 2020-21, Dŵr Cymru, Northumbrian, Affinity and SES Water all reported an AICR of below 1, implying that for those companies cash generated from operating activities was insufficient to service outstanding debt this year.

There are a variety of reasons for why reported AICR is low for these companies including the effects on revenue of changes in consumer demand and consumption related to the pandemic, changes to investment, cost profiles with some additional expense as a result of COVID-19, and in the case of SES Water one-off costs associated with the implementation of new systems.

RoRE – Returns on notional regulatory equity, 2020-21



Source of RoRE Variance	Low	High	Simple average
Base	**3.78%**	**4.43%**	**4.05%**
Financing	(3.22)%	4.28%	(0.29)%
Operational	(6.80)%	2.13%	(1.49)%
Other	(0.14)%	0.22%	0.02%
RoRE	(0.74)%	6.60%	**2.29%**

At PR19 we set an allowed return on equity for a notional capital structure that remunerates investors for the risks of their investment.

We expect efficient companies should be able to earn their allowed return on regulatory equity* (the Base), with there being scope for companies to achieve a higher return where they outperform their performance commitments and cost allowances (totex, cost of debt and retail).

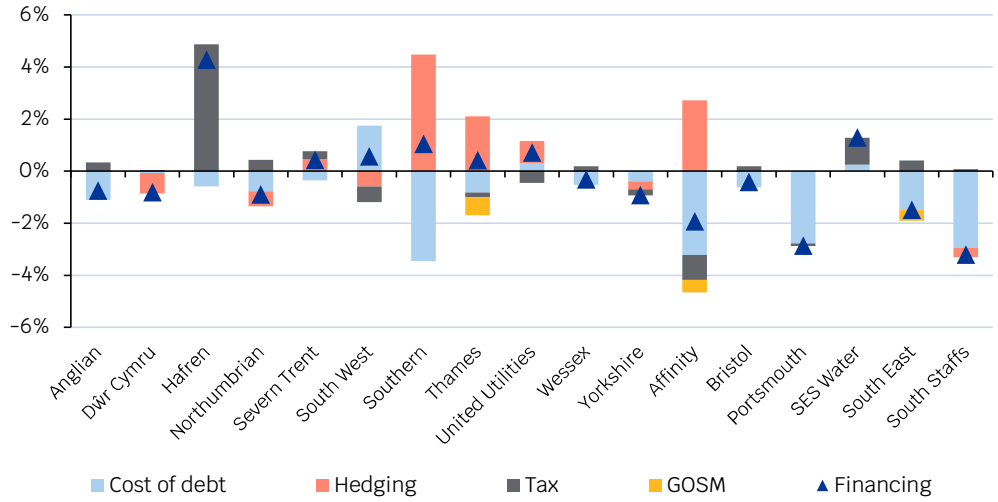
This chart compares the Base return determined at PR19 for each company to the return on regulatory equity (RoRE) they have reported for 2020-21 by reference to the notional capital structure. The table presents the range and average impact that financing and operational factors have had on the Base return.

For 2020-21, three companies reported a RoRE above their Base return (Severn Trent, South West and United Utilities). For all other companies, reported RoRE is below Base, with Southern, South East and South Staffs reporting a negative RoRE.

Additional commentary is set out on the following pages, however we highlight that as 2020-21 is the first year of a new price control and given the wider economic impacts on companies, including the effects of COVID-19 and a low inflationary environment, it is premature to draw firm conclusions on companies' underlying performance and their delivery of the PR19 FD at this time.

*Base return on regulatory equity varies between companies for the following key reasons; different speeds of transition to CPIH indexation at PR19, variations in the impact of the retail price control margin, specific company adjustments and for 2020-21 returns set by the CMA for the appealing companies.

RoRE – Financing out/(under) performance, 2020-21



Source of RoRE Variance	Low	High	Simple average
Cost of Debt	(3.45)%	1.75%	(0.99)%
Hedging	(0.79)%	4.49%	0.47%
Tax	(0.96)%	4.87%	0.32%
GOSM	(0.69)%	0.00%	(0.09%)
Financing	(3.22)%	4.28%	**(0.29)%**

The chart and table analyse the impact of reported financing factors on the Base equity return for the notional structure. The table reflects the impact across the sector as a whole, specifically the maximum outperformance and underperformance reported and the average on a simple basis.

Cost of debt and hedging: With the exception of South West who reported the lowest cost of debt for 2020-21, all companies were either broadly in line with or underperformed compared to their cost of debt allowance on a real basis in the period.

As noted, a key driver for this is the low inflationary environment, with companies comparing their cost of debt adjusted for outturn inflation (real basis) to a cost of debt allowance which was set in reference to a higher long term inflation assumption.

For some companies this under performance was wholly or partly offset by the impact of their hedging arrangements reducing the overall net interest cost/rate.

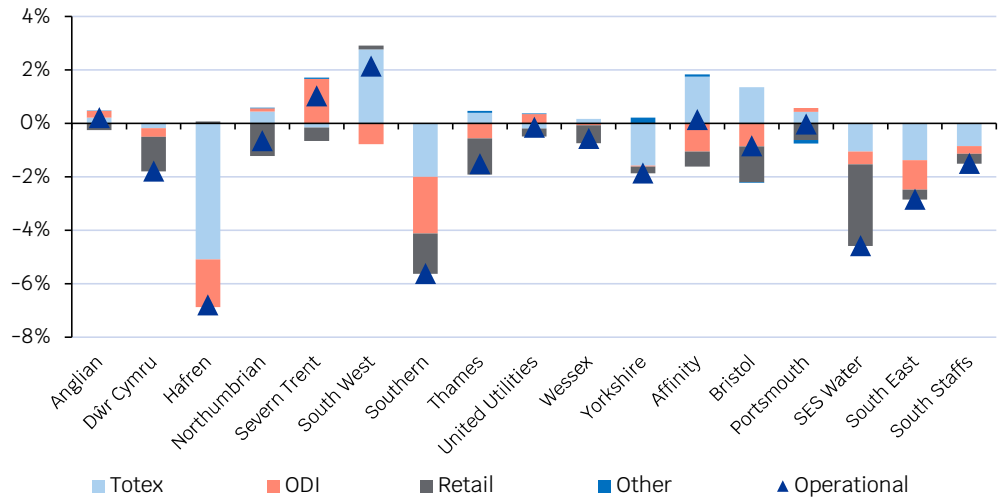
Tax: Performance against allowed corporation tax in the PR19 FD has been impacted by a range of factors to date including a higher rate of corporation tax than applied at PR19 (19% compared to 17%), generally lower taxable profits and variation in capital allowances for instance due to acceleration of capital programmes*.

Hafren reported the most notable impact on RoRE due to the company reporting a tax credit in the period compared to an assumed tax charge.

Gearing outperformance sharing mechanism (GOSM): Thames, Affinity and South East all reported an adjustment to RoRE under the GOSM as result of holding regulatory gearing positions above the threshold of 74%.

*Our PR19 methodology introduced a mechanism which will take account of any changes to corporation tax or capital allowance rates after we make our final determinations, as these are significant drivers of the tax allowance. We will make these adjustments at the end of the period.

RoRE – Operational out/(under) performance, 2020-21



Source of RoRE Variance	Low	High	Simple average
Totex	(5.09)%	2.77%	(0.29)%
ODIs	(2.12)%	1.67%	(0.41)%
Retail	(3.05)%	0.14%	(0.79)%
Operational	(6.80)%	2.13%	**(1.49%)**
Other	(0.14)%	0.22%	**0.02%**

The chart and table analyse the impact of reported operational factors on the Base equity return for the notional structure. The table reflects the impact across the sector as a whole, specifically the maximum outperformance and underperformance reported and the average on a simple basis.

Totex: Companies performance against Totex allowance is set out in detail in the Service Delivery Report, but in short our observations are in line with there being a mixed impact on RoRE for 2020-21*.

Whilst many companies reported cost increases, in part driven by the effects on the economy of the pandemic for instance shifts in household and non-household consumption impacting power and network activity costs, efficiencies and savings elsewhere have wholly or partly offset the impact.

A number of companies reported making additional investment (overspend) in the year to target areas of efficiency and service delivery, which may support future financial rewards.

Outcome delivery incentives (ODIs): The chart reflects the financial consequence of performance against commitments as reported.

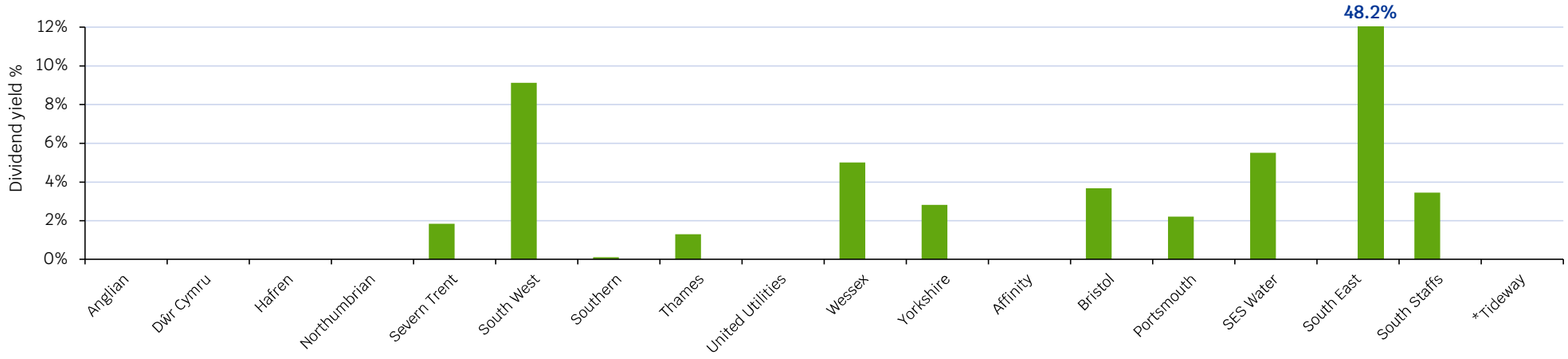
The actual overall reward or penalty that companies will receive may differ to that reported by companies in their APRs following Ofwat's 2020-21 in-period ODI assessment process**.

Retail: Nearly all companies underperformed with operating costs for retail activities being higher than allowed in the retail price controls. Companies have predominately reported this as being COVID-19 driven with increases in bad debt provisioning and debt management costs.

Provisioning across the companies ranges in scale, and at this time, the extent to which these provisions will be utilised is uncertain.

*Totex out/underperformance is calculated after adjusting for timing differences and the company sharing ratio with customers.
**On 11 November 2021, we published our final determinations confirming the payments due to companies or customers as a result of water company performance against their 2020-21 performance commitments. Company performance on per capita consumption will be reviewed at the end of the 2020-25 period, rather than by individual year.

Dividend Yield – For the year ended 31 March 2021



All dividends paid by appointed companies in 2020-21 are reflected in the total dividend yield presented above.

A number of companies determined not to pay dividends in 2020-21 for reasons including to support resilience and economic uncertainty*.

The yield reported by South East of 48.2% predominately reflects a one-off dividend of £136.0m which was used to repay an inter-company loan due to the appointed company. Excluding this one-off payment, the company paid a dividend yield of approximately 2.5%.

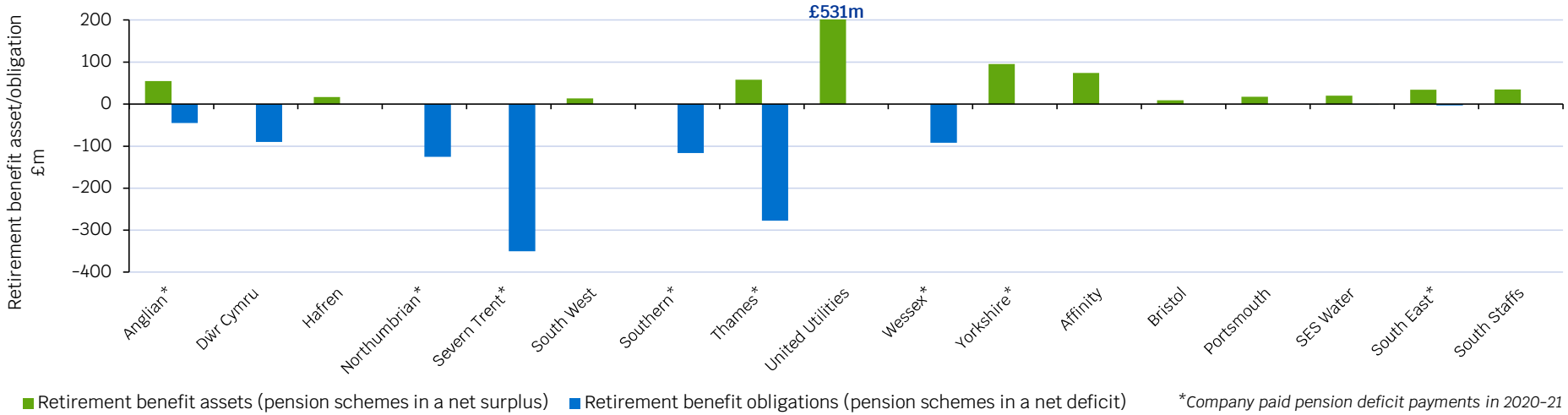
The dividend paid by Bristol (£5.9m) was also principally used to partially repay an inter-company loan due to the appointed company.

A number of companies declared a dividend relating to the period to 31 March 2021 for payment post year end. This will appear in companies reporting for the financial year ending 31 March 2022.

At PR19 all companies subject to price controls agreed to adopt dividend policies that aligned with our expectations to reflect performance delivery for customers. In Section 2 we set out in overview the conclusions of our assessment for 2020-21.

*Tideway deferred all distributions in the year (shareholder loan interest and repayment of principal).

Defined Benefit Pension Schemes – At 31 March 2021



All of the companies that we regulate have one or more defined benefit (DB) pension scheme. Many of these schemes are currently in surplus and all companies have, to varying extents, taken steps to better manage their pension obligations and reduce risk over time.

The chart presents the DB pension scheme obligation and/or asset of each company as reported on their balance sheet**.

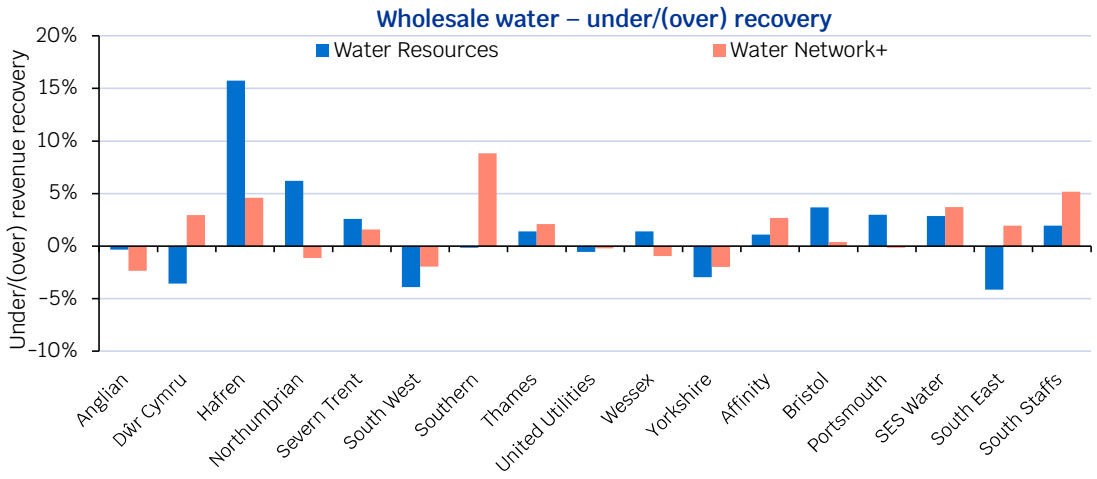
If the value of assets held by a DB pension scheme are less than the actuarially calculated pension liability, a recovery plan must be put in place to fund that deficit. At 31 March 2021 nine companies had a pension scheme(s) that was in deficit.

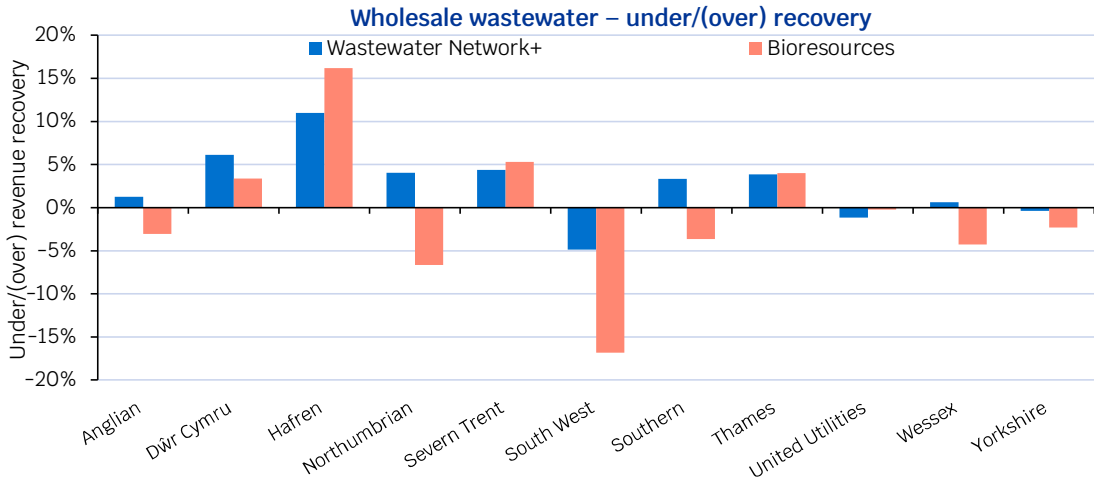
For nearly all companies the pensions accounting position deteriorated compared to prior year end i.e. the pension asset decreased/obligation increased. This has been driven largely by market movements including falls in corporate bond yields, an increase in inflation expectations and continued investment market volatility.

It is important to note that companies' pension cash commitments are driven by a separate valuation process (typically conducted every 3 years and in negotiation with pension trustees, in line with relevant pension legislation and regulation), not the outcome of financial reporting. It is not unusual for the pension position reported in the balance sheet to differ to the pension position that is driving cash contributions, as liabilities are valued on different bases.

**YKY and SSC do not account for their retirement benefit schemes in the appointed company, data sourced from South Staffordshire Water PLC annual report and financial statements for the year ended 31 March 2021 , and Kelda Holdings Limited, annual report and financial statements, year ended 31 March 2021.
Pension schemes in deficit include unfunded schemes.

Wholesale Revenue Recovery – For the year ended 31 March 2021





There are four separate wholesale price controls that companies may have: water resources, water network plus, wastewater network plus and bioresources to reflect different markets. WASCs have all four price controls since they offer both water and sewerage services to customers*.

The charts compare each companies reported revenue allowance by price control (nominal terms), to the actual revenue they recovered in the period. This includes grants and contributions (the revenue cap).

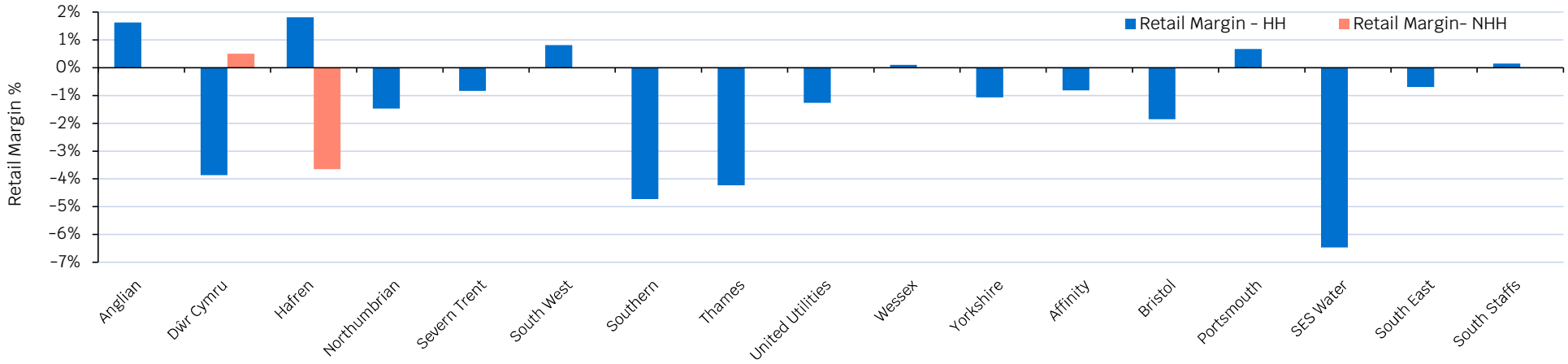
Overall, wholesale revenue recovered in 2020-21 by the sector was below allowed revenue, with a total under recovery of approximately 1.3%.

This has been attributed mainly to a material increase in household consumption and reductions in non-household consumption and developer activity, driven largely by lockdown restrictions of COVID-19. There is variation between price controls and companies reflecting that companies have different customer profiles and demands to meet.

Revenue reconciliations allow companies to collect revenues that are under or over recovered either in a subsequent year of the price control or at the end of end of the price control period.

*There are also separate controls for individual companies reflecting significant investments that these companies are undertaking, including Havant Thicket Activities (for Portsmouth Water) and the Thames Tideway Tunnel (for Thames Water).

Retail Profit Margin – For the year ended 31 March 2021



Retail controls are set on the basis of retail costs plus a net margin. The retail margin reported by each company in their APR differs to that presented in the chart above due an error in the APR formula. The margin has been recalculated using company data.

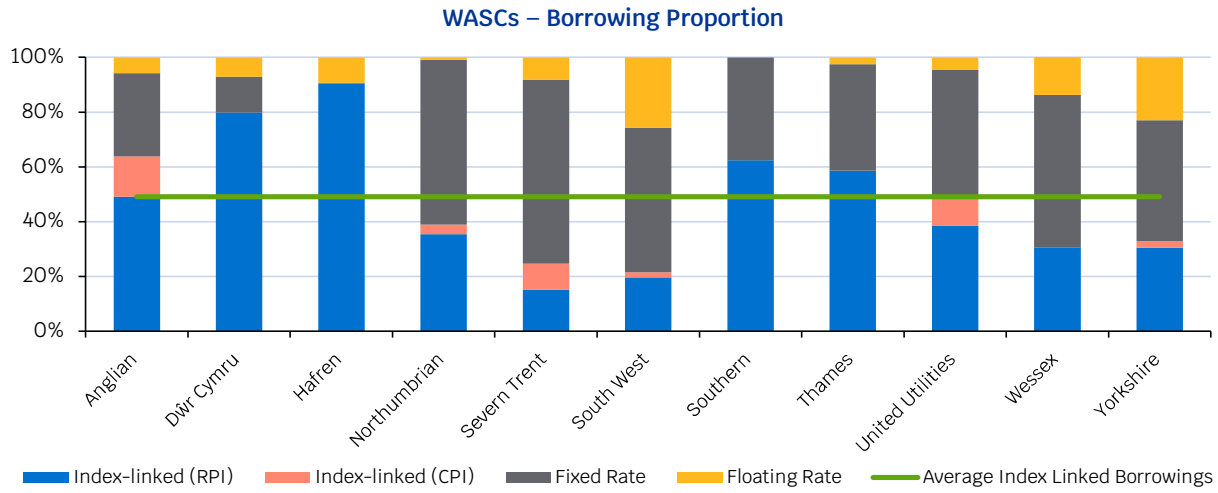
For PR19 we retained a retail net margin cap of 1.0% for residential (household, HH) and non-contestable business retail services (non-household, NHH). The main revenue risk associated with these price controls arises from bad debt risk. As retail (and bioresources) is an average revenue control (with an outturn volume adjustment reducing the cost performance risk) there is no sharing of retail cost over/underspend with customers.

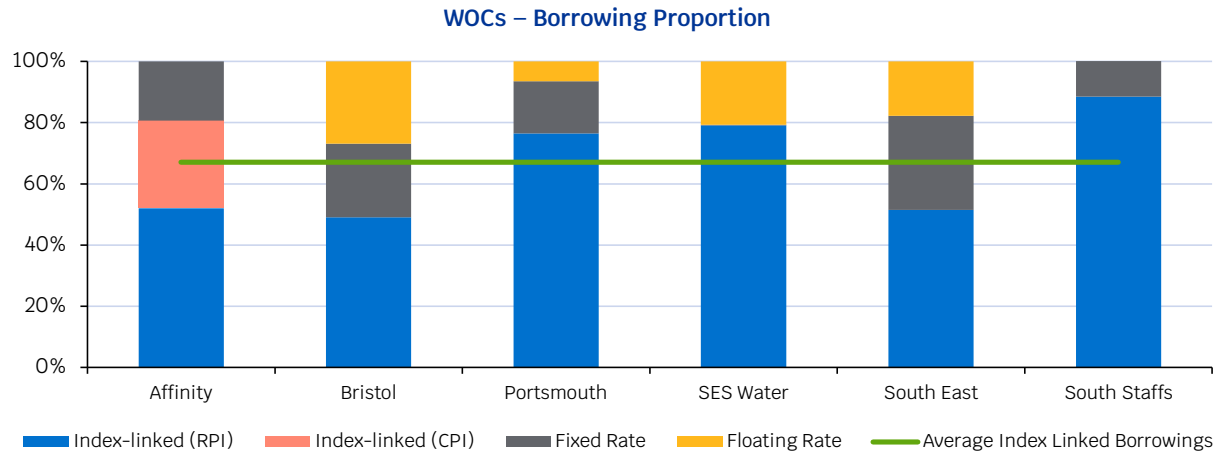
Only the Welsh companies* have a separate business retail (NHH) control due to the limited extent of competition for business retail customers of companies whose areas are wholly or mainly in Wales. Revenue from business retail customers represents a small proportion of total revenue for these companies**.

Most companies reported a negative retail household margin for 2020-21 with costs above those allowed in final determinations. As noted in RoRE, most companies have reported an increase in bad debt and debt management related costs reflecting factors including an increase in household revenue and in the number of customers on social and support tariffs, increased billing of properties that were previously identified as void, together with longer term economic uncertainty.

*In April 2017, the business retail market in England was opened to competition. Reflecting the policy position of the Welsh Government, the new business retail market was not extended to customers of Welsh water companies. Customers of Welsh water companies are only able to switch their water supplier if they are supplied with at least 50Ml of water per year.
** In 2020/21 the licence of South West was expanded to include the Isles of Scilly. Revenue and margin reflects income from business customers on the Isles of Scilly. Margin for 2020-21 of 0.01%.

Borrowings – Debt composition at 31 March 2021





Borrowings including preference shares, included withing fixed rate. Data excludes Tideway

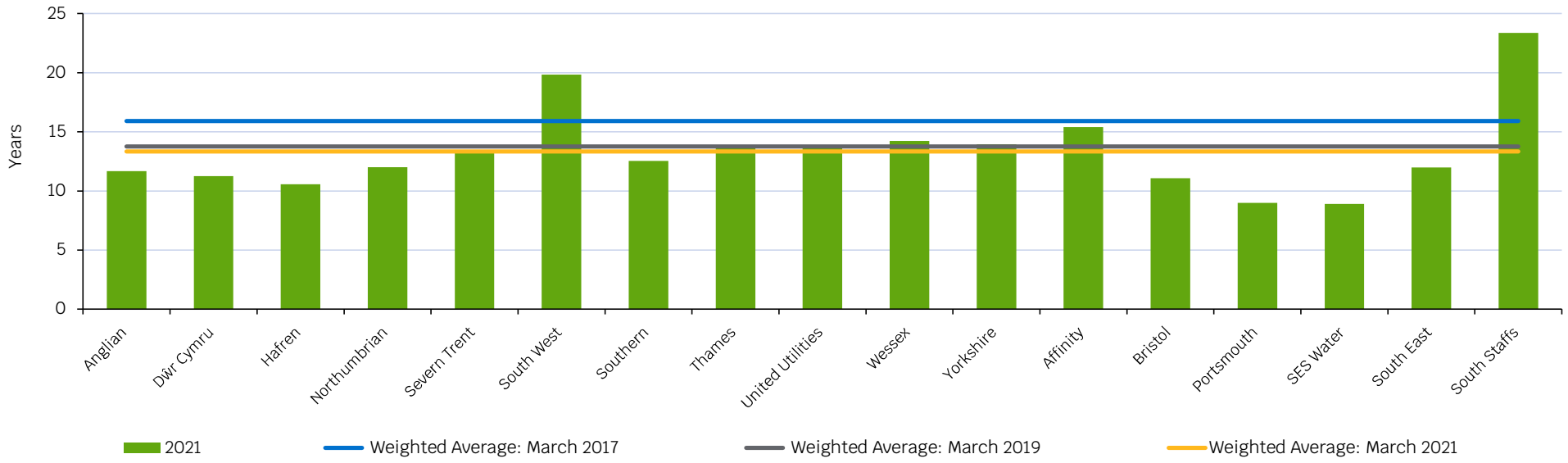
The charts are based on total borrowings after the impact of any relevant financial derivatives.

Borrowings in the sector total £59.3bn at 31 March 2021 (net debt £56.2bn), which sits largely with the WASCs with £3.3bn attributable to WOCs.

Companies use index-linked debt and other index-linked instruments to manage their exposure to inflation risk. The use of index-linked debt impacts the cash interest payments each year, with index-linked liabilities increasing year on year.

Historically, index-linked instruments have been linked to RPI. However, with price controls transitioning from RPI to CPIH from 2020, companies have made increasing use of CPI-linked instruments.

Borrowings – Weighted average years to maturity at 31 March 2021

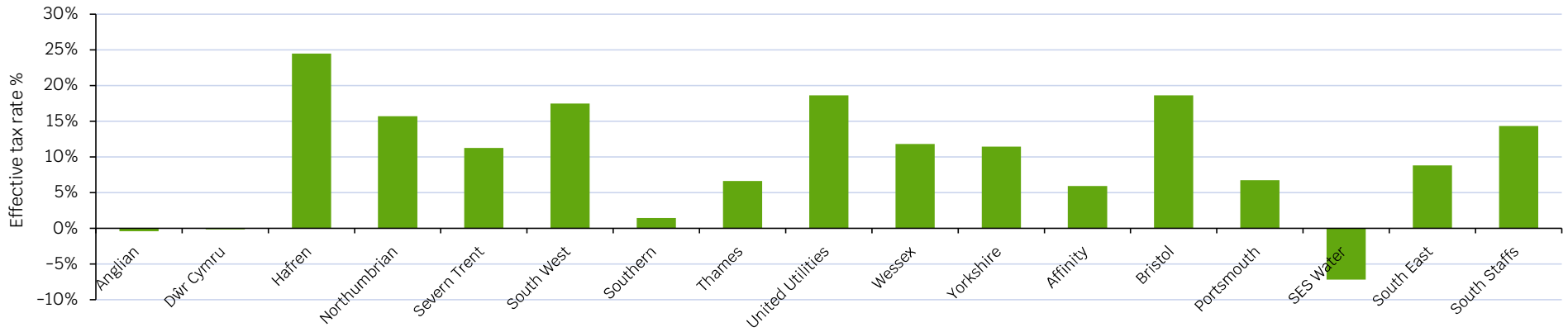


Companies use a portfolio of both long and short term debt to finance their business.

The weighted average debt term across the sector at 31 March 2021 was 13.3 years. Over time, reported debt maturity across the sector has trended down (15.9 years at 31 March 2017, 13.8 years 31 March 2019), being indicative of companies issuing at the shorter end of the yield curve.

The largest year-on-year movement was Hafren whose weighted average years to maturity at March 2020 was impacted by a restructuring of its debt finance in the 2018-19 financial year.

Effective Tax Rate – For the year ended 31 March 2021



The chart presents each company's effective tax rate for 2020-21, calculated as the annual tax charge as a percentage of the profit before tax and fair value movements for the appointed business.

The standard rate of corporation tax for 2020-21 remained in line with prior year at 19%. For the sector the effective tax rate for 2020-21 was lower than the standard rate of tax, with rates impacted by various factors such as tax reliefs available, accounting treatment, interest and other allowed expenditure.

Both Anglian and SES reported a tax credit for the current year and therefore a negative effective tax rate. Whilst both Hafren and Affinity also reported a tax credit for the current year, as they generated a loss before tax for 2020-21 the companies have a positive effective tax rate.

Companies can obtain tax relief on certain types of expenditure (capital allowances), which are treated as business expenses and so reduce taxable profit. Where capital allowances are in excess of accounting depreciation, tax deductions are brought forward resulting in lower effective tax rates, and allowances not claimed may be available as a deduction against future taxable profits.

Where an appointed company is part of a group of companies which are taxable as UK companies, the profits or losses of those companies within the group can be set off against one another in the financial year (Group relief). At PR19 we confirmed our requirement that companies must pay in full for any group relief received.

Section 2 – Dividend Policies

Assessment Summary

Section 2: Introduction

At PR19, following consultation, we set out our expectations for a reasonable dividend policy, including factors we expected companies to take into account in the design and application of those policies. These expectations were set out in pages 113-120 of the 'PR19 final determinations: Aligning risk and return technical appendix' and the disclosure requirements were also reflected in 'RAG 3.12 – Guideline for the format and disclosures for the annual performance report'.

Our final determinations proposed a base dividend yield of up to 4% as a reasonable level for companies that have little real RCV growth and that perform in line with our determination in 2020-25. We said that where a company must finance material growth of the asset base or where long term financial resilience is at risk, it may need to reduce this base dividend or investors may need to invest more equity.

The factors we expected companies to take into account include whether companies are meeting their obligations and commitments to customers, performance in delivering against their determination, employee interests, pension obligations, financial resilience and the need to finance future investment.

2020-21 was the first year that the 2020-25 dividend policies have been applied. We have carried out an assessment of the disclosures made by companies in their 2021 APRs, focussing on two assessment areas:

- Does the policy stated in the APR meet the expectations set out in our final determinations and the disclosure requirements in RAG3.
- Does the application of the dividend policy and the explanation of dividends paid meet our expectations.

Section 2: Our assessment of dividend policies and their application

Does the policy stated in the APR meet the expectations set out in our final determinations and the disclosure requirements in RAG3?

All companies included either their dividend policy in their APR or included a link to their policy contained in a separate published document. We note that Hafren included a summary of its dividend policy and a link to Severn Trent's dividend policy.

In most instances, companies have provided less detail on the policy in the APRs than was provided in the PR19 process. Going forward, we expect companies to be transparent about their how their policies consider delivery for customers.

Does the application of the dividend policy and the explanation of dividend paid meet our expectations?

Our assessment of 2021 APRs concludes that overall, companies could still be clearer about how decisions on dividends declared or paid meet delivery for customers. The disclosures do not provide sufficient transparency for stakeholders.

The reasons for this fall into three categories:

- Six companies explained the level of dividend on the basis that it was all repaid as interest by the group or that it reflected the minimum level required to allow the group to service existing debt obligations. As it is the regulated company that holds the licence, public trust is served best where the level of dividend is explained in relation to performance delivery for customers, irrespective of the obligations of the wider group.

- Some simply stated that the dividend yield was lower than the 4% expectation set out at in the FD and no further explanation was provided. Our expectation of a 4% dividend yield only applies to a company performing in line with FD expectation and with low RCV growth. Even when a company pays a dividend of less than 4%, it still needs to explain this in relation to its performance, RCV growth and future investment needs.

- Where companies did reference delivery for customers, most only made general statements such as overall good performance but without sufficient explanation or evidence to support this conclusion.

We continue to engage with companies to encourage them to improve transparency in this area which is important to maintain public trust.

Section 2: Summary of our assessment for 2020-21

Company	RCV Growth over 2020-25 (FD)	2020-21 reported dividend yield on actual equity	Is the dividend policy stated in the APRs and does it reference key factors as set out in our expectations	Does the application of the dividend policy and the explanation of dividend paid meet our expectations?
Anglian	9.5%	0.0%	✓	-
Dŵr Cymru	2.8%	0.0%	✓	✓
Hafren	35.9%	0.0%	✓	-
Northumbrian	6.5%	0.0%	✓	-
Severn Trent	3.8%	1.8%	✓	×
South West	0.4%	9.1%	✓	×
Southern	10.7%	0.1%	✓	×
Thames	11.5%	1.3%	✓	×
United Utilities	(4.5%)	0.0%	✓	-
Wessex	10.6%	5.0%	✓	×
Yorkshire	5.7%	2.8%	✓	×
Affinity	24.8%	0.0%	✓	✓
Bristol	(2.3%)	3.7%	✓	✓
Portsmouth	12.1%	2.2%	✓	×
SES Water	7.6%	5.5%	✓	×
South East	3.1%	48.2%	✓	×
South Staffs	15.1%	3.5%	✓	×

Anglian, Dŵr Cymru, Hafren, Northumbrian, United Utilities and Affinity paid no dividend in the year. Whilst narrative on performance for customers and explanations of the impact on dividend paid may not have been necessary for this year, going forward we expect that when dividends are paid, APR narrative should address delivery for customers.

However, Dŵr Cymru and Affinity included narrative to explain that obligations and commitments to customers would be taken into account when considering the payment of any future dividends. Bristol paid a dividend in the year and attempted to set out and quantify how the service delivered for customers and other considerations impacted on dividend paid in 2020-21.

The table includes real RCV growth over 2020-25 as referenced in the FD because our expectation of a 4% base dividend yield only applies to companies who have little real RCV growth.

Section 3 – Long Term Viability Statements

Assessment Summary

Section 3: 2020-21 Assessment and key findings

Long term viability statements (LTVS) are important as they provide stakeholders with an understanding of a company's view on the key risks it faces, how it monitors and manages those risks, and its ability to withstand those risks should they crystallise, both standalone and in combination.

For 2020-21 we have reviewed companies' published statements in line with our current information notice (IN 19/07), which provided clarity on our expectations regarding the approach and level of reported information in assessments.

Overall, we found that companies met expectation in terms of defining the range of risks they have identified and general mitigation measures potentially available to them. However, there is variation in the quality of companies' reporting of their impact assessment of the principal risks identified. We consider there to be scope for improvement, particularly in companies reporting of the sensitivities applied for testing their resilience and the process of board review.

We will engage with companies on the areas where we believe reporting and transparency can be strengthened and better aligned to our guidance. This is important to maintain public trust and support stakeholder understanding of how risk is assessed by the boards of the regulated companies.

Period of assessment

All companies prepared a LTVS and all assessed their viability over a period ranging between 7 and 10 years. This is in accordance with our expectation that companies look forward at least 5 years. All companies provided some explanation to support the appropriateness of the period they had chosen.

Risk identification and disclosure

All companies set out, either in their APRs or in documents referenced, a risk appraisal.

Overall, we found companies' reporting of risks identified to be in line with our expectations. Risk reporting was in the main clear, included a range of relevant risks, a view of risk evolution, views of impacts broadly including across financial and operational performance, together with an overview of potential general mitigating actions that could be taken to manage adverse effects should such risks arise.

Section 3: 2020-21 Assessment and key findings

Risk assessment and stress testing

This was the area of most variance between companies.

IN19/07 sets out our expectation that companies test their forward looking financial and operational plans against severe, plausible and reasonable scenarios reflecting the principal risks identified and to set out details of the stress testing carried out and outcomes.

For some companies, the scenarios and sensitives tested and/or how they linked to the risks identified lacked transparency. We expect companies to determine their own scenarios and explain and justify why the scenarios are relevant to their own circumstances.

Some companies set out the outcomes of their stress testing more clearly than others. Where outcomes of stress testing highlight the potential for resilience issues, we expect greater detail on mitigating actions and the assumption that those actions would be reasonably available.

Assurance

As a minimum companies should clearly detail the internal review processes they have followed. We found some companies provided a more comprehensive description of their review processes and structures in place including details of forums, committees, board meeting frequency and external review. For some companies, the internal review undertaken including how the board reviews and challenges management's assessment of risk, was not sufficiently detailed.

We will engage with companies further on these issues where appropriate.

Appendices

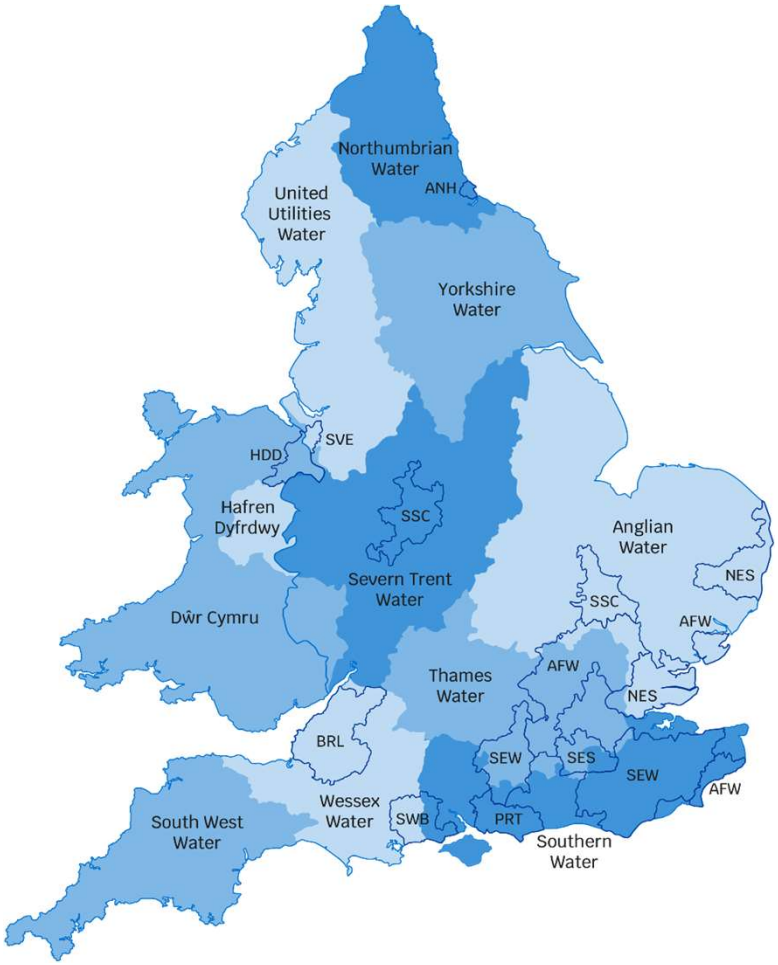
Appendix 1: Glossary and abbreviations

Abbreviation	Definition	Abbreviation	Definition
AICR	Adjusted Interest Cover Ratio (cash). Calculated as FFO adjusted for RCV run-off divided by cash interest paid. Measures scope to make interest payments after meeting costs that have been expensed and assuming RCV run-off can not be reduced.	**FFO and FFO/Net Debt**	Funds from Operations is cash generated from operating activities adjusted to remove changes in working capital, less net interest and tax paid. The FFO ratio measures companies' debt burden in relation to operational income. This is a key financial ratio for rating agencies, although each rating agency may make specific adjustments to FFO and/or net debt for its calculations.
APR	Annual Performance Report, published by the appointed companies.	**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.
Bioresources	Wastewater sludge transport, treatment, recycling and disposal.	**Notional structure**	We set a notional capital structure that is consistent for all companies with a proportion of debt to total regulatory capital at 60% for PR19.
bps	Basis points, one hundredth of a percentage point.	**pps**	Percentage points
CPI/CPIH	Consumer Prices Index/ Consumer Prices Index including owner occupiers' housing costs.	**PR14**	The price review which covers the period 2015-2020 (1 April 2015 to 31 March 2020).
FD	The final determination of allowed revenues and costs set out by Ofwat.	**PR19**	The price review which covers the period 2020-2025 (1 April 2020 to 31 March 2025).

Appendix 1: Glossary and abbreviations

Abbreviation	Definition	Abbreviation	Definition
RAGs	Regulatory Accounting Guidelines	**RoRE**	Return on Regulatory Equity
RCV	Regulatory capital value, presents a measure of the capital base of a company when setting price limits. The RCV is inflated each year to maintain the RCV at current prices	**RPI**	Retail Price Index
RCV run-off	The element of RCV that is recovered in any one year	**Securitisation**	A company adopting a set of financing arrangements with highly covenanted features
Real	Interest rates, prices and costs are said to be in real terms if they exclude the impact of inflation	**Totex**	Total expenditure, allowed in, or reported against, a price determination
Regulatory equity	RCV less net debt	**WASC**	Water and wastewater company
Regulatory gearing	Net debt divided by RCV	**WOC**	Water only company

Appendix 2: Company glossary



Water and wastewater companies	
Anglian	Anglian Water Services Limited
Dŵr Cymru	Dŵr Cymru Cyfyngedig
Hafren	Hafren Dyfrdwy Cyfyngedig (previously Dee Valley Water Limited)
Northumbrian	Northumbrian Water Limited
Severn Trent	Severn Trent Water Limited
South West	South West Water Limited
Southern	Southern Water Services Limited
Thames	Thames Water Utilities Limited
United Utilities	United Utilities Water Limited
Wessex	Wessex Water Services Limited
Yorkshire	Yorkshire Water Services Limited
Water only company	
Affinity	Affinity Water Limited
Bristol	Bristol Water plc
Portsmouth	Portsmouth Water Limited
SES Water	Sutton and East Surrey Water plc (trading as SES Water)
South East	South East Water Limited
South Staffs	South Staffordshire Water Plc
Infrastructure provider	
Tideway	Bazalgette Tunnel Limited
Credit Rating Agencies	
Moody's	Moody's Investors Services, Inc.
S&P	S&P Global Ratings
Fitch	Fitch Ratings, Inc.

Appendix 3: Credit ratings, post 31 March 2021 updates

Company	Rating Agency	Credit Rating at 31 March 2021	Revised Rating/Outlook
Affinity	Moody's	Baa1 (Negative)	Baa1 (Stable)
Anglian	Moody's	Baa1 (Stable)	A3 (Stable)
Anglian	S&P	A- (Negative)	A- (Stable)
Bristol	Moody's	Baa2 (Stable)	Baa2 (Positive)
Northumbrian	S&P	BBB+ (Credit Watch Negative)	BBB+ (Negative)
SES Water	Moody's	Baa2 (Negative)	Baa2 (Stable)
Yorkshire	Moody's (Corporate Family Rating)	Baa2 (Negative)	Withdrawn
Yorkshire	S&P	A- (Negative)	A- (Stable)

In this table we set out relevant credit rating and/or outlook changes that have occurred between 31 March 2021 and report publication 30 November 2021.

We state only those changes that impact on the lowest credit rating that is monitored for licence compliance purposes.

Appendix 4: 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.

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 its 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)*. 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.

*On 13 August 2015, Ofwat designated Bazalgette Tunnel Limited as an infrastructure provider responsible for the delivery of the Thames Tideway Tunnel project. The RCV for Tideway is calculated based on cost and so uses a different mechanism to the rest of the industry. Tideway does not generate distributable profits rather shareholders receive a return on their investment through a combination of payments of interest on loans and partial repayments of those loans during the construction phase of the project.

Appendix 5: Explanatory notes

1. Published Information

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 its 2020-21 APRs prior to our publication of this report, we have updated the data in line with the revisions made by companies. If companies were to restate figures and / or revise their 2020-21 APRs following the publication of this report these changes will not be reflected in this report.

2. Competition and Markets Authority (CMA), PR19 Final Determinations

Four companies: Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water made an appeal to the CMA asking for a redetermination of their price controls for the 2020-25 period. The CMA published its final redetermination in March 2021 which resulted in revisions to the FDs of those companies including in regards to cost allowances and the rate of return received by investors. Where comparisons are made to PR19 FDs the data presented has been updated to reflect the appeals outcome.

3. Retail Profit Margin

In table 4H companies report the retail profit margin for their retail household (HH) and non-household (NHH) business. For the 2020-21 APRs the formula for the calculation of the retail margin was incorrect. The margin for each company has been recalculated as set out below and therefore the margin as presented in this report is different to the margin reported by companies in their APRs. The calculation is based on data provided by companies in other APR tables. The relevant formula will be updated for future reporting.

Retail HH/NHH Profit Margin % = Retail HH/NHH Profit or (Loss) / Total HH/NHH Revenue (wholesale and retail, Table 2I)

Retail HH/NHH Profit or (Loss) = Retail Total, HH/NHH Revenue (Table 2I) – Total Retail HH/NHH Costs (Table 2C)

Appendix 5: Explanatory notes

4. 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 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.

5. Regulatory Investigations' impact on revenue recovery

Regulatory investigations into both Thames and Southern have resulted in packages of commitments that ensure that both companies return revenue to customers. Due to this, overall revenue recovery and certain metrics may be adversely impacted while the companies continue to return money to customers. For more information on these cases see links below:

Thames Water: Investigation into Thames Water's failure to meet its leakage performance commitments - Ofwat

Southern Water: Investigation into Southern Water's wastewater treatment sites and the company's reporting of relevant compliance information to us – Ofwat

6. Investment grade credit rating, cash lock-up

Where an investment grade issuer credit rating is not maintained, or where one or more ratings at the lowest investment-grade is also put on review for possible downgrade or outlook negative, a cash lock-up clause in the licence will automatically be triggered. While in cash lock-up, the regulated company is unable to make certain payments, including dividends, without the prior approval of Ofwat.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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