December 2022

# Monitoring financial resilience report 2021-22

Ofwat

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This year the Monitoring Financial Resilience Report (the MFR), our annual publication, is divided into the following areas together with appendices:

[Key messages](#) – Our key messages and observations on financial resilience across the sector.

[Ofwat monitoring and engagement and company activity to strengthen financial resilience](#) – We set out our categorisation and approach for our monitoring and engagement of the regulated companies*, and highlight some of the steps and actions companies have taken to strengthen and support their financial resilience.

[Financial metrics analysis and credit ratings](#) – The section captures and presents some of the financial data submitted by the companies in their Annual Performance Report (APR) for the year ending 31 March 2022. The supporting data underpinning the charts has been published on our website.

[Summary of our assessment of dividends paid, policies and reporting](#) – In this section we provide analysis of dividends paid this year, alongside our assessment of whether companies have met our expectations around transparency and explaining how performance delivered to customers has been taken into account.

[Summary of our assessment of long term viability statements](#) – We provide an overview of our assessment against our expectations for transparency of reporting.

Through the MFR, we aim to promote a focus on efficient investment that secures long-term resilience and delivers long-term value for money for customers and the environment.

* The 17 largest companies in England and Wales. Bazalgette Tunnel Limited (Tideway) is referenced separately in the report as its activities and the way in which it is regulated differs to the rest of the industry.

# Key messages 1

**Driven by Ofwat intervention and regulatory guidance, several companies have taken steps to strengthen and support their financial resilience this year. More than £2 billion of new equity has been injected or committed to the regulated companies since March 2021.**

This includes steps taken by Southern and Yorkshire, both of whom were highlighted in our 2020-21 MFR report as companies that needed to take action to strengthen their financial resilience.

To date we have seen c£530 million of new equity injected into Southern and significant commitments from Yorkshire including around repayment of an intercompany loan and reducing its gearing level.

More recently Thames, with whom we have been engaged over the year, has also set out a plan to raise £1.5 billion of new equity before the start of the next price control to enable the turnaround of its operational performance and in support of its financial resilience.

**We are monitoring and engaging with companies on a prioritised basis, based on our assessment of their financial resilience. Where we have concerns that are not explained or addressed, we challenge companies on what actions they could take to strengthen or protect their financial resilience in the longer term.**

Our highest priority for engagement is currently with Thames, Southern, Yorkshire, SES and Portsmouth.

We assess the long term financial resilience of each company based on a range information, in the round and over time, and target our monitoring and engagement to where we see most need.

Based on our assessment and engagement, company action may be required to address financial resilience concerns raised. Where necessary we will use our regulatory tools to intervene.

Our recent consultation work to strengthen regulatory ringfencing licence conditions is also seeking to incentivise companies to ensure they are, and remain, financially resilient.

**For 2021-22 we have seen some companies again fail to meet our expectations to clearly set out and explain the link between their dividend decisions and payments with performance delivery for customers.**

In particular, both Northumbrian and Portsmouth fell short of our expectations when considered in the context of the level of dividend they paid and their relative financial resilience.

We are seeking to update the licences of all companies to include this expectation as an explicit requirement.

We will again provide feedback and will be challenging companies on their dividend policies and payments accordingly.

Companies that are not meeting our expectations, particularly where dividends paid are above the base yield assumed at PR19 and there is not a clear link to performance, will need to set out the actions they are taking to address this.

# Key messages 2

## Investor interest in the sector has remained strong.

Over the year we have seen companies raise new equity from both incumbent and new investors, accelerate capital investment plans and reinvest outperformance, recognising the opportunity for reward and long-term value creation in delivering for customers and the environment.

More recent transactions include a £250 million equity placement by Severn Trent to help fund its Green Recovery programme, which was oversubscribed.

The anticipated acquisition of a minority interest in Northumbrian at a reported premium.

There has also been high interest in recent debt raises, again suggesting ongoing interest and appetite for the sector.

## The rapid increase in inflation has had both positive and negative impacts on companies during 2021-22. While helping to drive down gearing, inflation has created some cost pressure and balance sheet volatility.

Average reported regulatory gearing across the sector reduced to 68.5% at 31 March 2022 (from 72.8%)*, in part driven by the positive impact of higher inflation on companies' regulated asset base.

It is our expectation that benefits that accrue to companies from the consequences of high inflation, as they are not linked to operational performance, are retained or reinvested and not distributed as outperformance.

In 2021-22 companies also reported increases in certain input costs, mitigated in part by actions taken like hedging power and chemicals prices, and increases in their inflation linked liabilities, including index-linked debt and associated interest expense (which have been largely non-cash impacts but have affected company earnings and net asset positions).

Whilst companies can benefit from inflation protections in the regulatory framework, they will need to manage costs and risk carefully. We will continue to monitor the impact of inflationary pressures on companies and the risk to financial resilience.

* Weighted average gearing excluding Tideway

## The regulatory framework provides some protections for companies from changes to economic assumptions over time. However, the uncertain economic outlook could put pressure on companies' credit metrics in the short term.

Economic conditions remain uncertain at this time with the rise in cost of living and customer affordability a particular focus for companies.

While the regulatory framework acts to provide some protection for companies over time, there is likely to be greater pressure on companies' credit metrics and cash flows in the short term, and potentially credit ratings.

This reinforces the importance of companies maintaining financial headroom and flexibility.

# Ofwat monitoring and engagement and company activity to strengthen financial resilience

# Ofwat monitoring and engagement

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We expect the regulated water companies to maintain a level of financial headroom so that they are able to manage short term volatility and shocks, and fund investment necessary to meet their obligations and commitments in the long term and improve performance where needed.

**We collect and consider relevant financial data and non-financial information from a range of sources, over time and in the round, and apply judgement in forming our view on companies' financial resilience.** Our assessment takes into account a range of matters, including known events and company actions that could impact financial resilience over the coming year and/or the longer term, and is intended to enable us and companies to plan for monitoring and engagement that is proportionate to the company's potential vulnerability to volatility and shocks.

This holistic assessment informs our prioritisation and approach to company monitoring and engagement. This is a sliding scale ranging from Standard/Routine as relevant to Action Required/Active, with a view in some cases to action being taken to address concerns. **Where necessary we will use our regulatory tools to intervene to strengthen and protect financial resilience.**

The type of matters that we take into account and that can impact on a company's financial resilience long term, and that might lead to an increase in our prioritisation for monitoring and engagement include:

- A weakening trend across key credit metrics, alongside lower credit ratings and the risk of downgrade.
- The scale of investment needed to address current performance relative to financial headroom.
- The complexity and risk presented by a financial structure or arrangement in place.
- Risks associated with undertaking a large capital project or implementation of new systems and processes.
- The impact of potential financial penalties or remedial measures including as a result of potential regulatory enforcement action.
- A lack of transparency around key polices and reporting and falling below expectations, including in regard to dividend policies and LTVS.

# Ofwat financial resilience categorisation

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Below is our latest categorisation of the regulated companies as based on our wider assessment and involvement on matters of financial resilience.

| Financial resilience status | Monitoring and engagement approach | Company (alphabetical) |
|---|---|---|
| **Standard**<br>No specific concerns with the financial resilience of the company that we are aware of at this time.<br>No specific company action expected to be required at this time. | **Routine**<br>Company is subject to ongoing monitoring, including through standard regulatory reporting and engagement. | Anglian, Bristol, Dŵr Cymru, Hafren, Severn Trent, South Staffs, South West, United Utilities and Wessex |
| **Elevated concern**<br>We have identified some concerns or potential concerns with the company's long term financial resilience that may require action to address. | **Targeted**<br>More frequent or targeted monitoring including engagement and reporting on a minimum bi-annual basis. | Affinity, Northumbrian, South East |
| **Action required**<br>Company action is being taken or is required, and/or commitments have been made to strengthen long term financial resilience. | **Active**<br>Close monitoring, engagement and reporting on improvements needed as a priority and at a senior level in Ofwat. | Portsmouth, SES Water, Southern, Thames and Yorkshire |

Regarding our **Elevated Concern/Targeted** category, the types of matters that can impact on a company's long term financial resilience, and that can trigger an increase in our prioritisation, include those set out on slide 6. In respect of those companies in our **Action Required/Active** category we comment as follows:

- **Portsmouth** – priority reflects largely the scale of the Havant Thicket reservoir undertaking relative to RCV and its complexity. Given the potential for such a significant project to impact on financial resilience, we have additional monitoring and company engagement in place.
- **SES Water** – matters include a weakening trend across certain key financial metrics coupled with a lower credit rating. SES has implemented new systems to improve performance, but the impact of these changes in not reflected in the 2021-22 financial statements.
- **Yorkshire** – the company has taken substantial steps this year which should strengthen its financial resilience over time. Whilst the company delivers on its commitments we continue to monitor and engage accordingly.
- **Southern and Thames** – having taken action and set out commitments, each company needs to demonstrate delivery of their turnaround plan to improve performance and financial resilience.

# Activity to strengthen financial resilience

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**A number of companies have taken steps during 2021-22 and post year-end to strengthen their financial resilience, in some cases as a result of Ofwat engagement and intervention, including:**

**Thames** – In June 2022 the company announced its shareholders' approval for its plan to spend an additional £2 billion in the period to 2025 (above the PR19 FD of £9.6 billion) to support improved performance and delivery of its business turnaround plan. Investors have agreed to contribute an initial £500 million of new equity, with support for an additional £1 billion to follow subject to certain conditions. As reported by the company the turnaround will continue into AMP 8 and additional shareholder support may be required to further support financial resilience.

**Yorkshire** – The company has agreed a structured plan to recover an intercompany loan which will improve its financial arrangements and support resilience. It has agreed to the recovery of the loans it made to other companies within its wider group, reducing its financial regulatory gearing to no higher than 72% by April 2025, undertaking a financial structure review and investing £180 million to reduce spills from storm overflows.

**Southern** – During the year a fund managed by Macquarie Asset Management acquired a majority stake in Greensands, the parent company of Southern Water, and invested £1 billion into the group. Of that amount, c£530 million has been directed into the regulated company to support capital investment, plans to improve operational performance and support its financial position. Progress against and delivery of the company's turnaround plan continues to be monitored by Ofwat.

**Anglian** – The company's financial restructuring completed in 2021-22 with £1.2 billion of new equity injected in the year. As a consequence, net debt and leverage has reduced significantly.

**South Staffs** – The group has implemented a new structure to ring fence regulated liquidity from other parent group non-regulated activities. In the year this included repayment of a £25 million intercompany loan that was owed to the regulated company, reducing its external debt requirements.

**Severn Trent** – During 2021-22 the company completed a £250 million equity placement to help fund its Green Recovery programme. In 2021 Ofwat awarded Severn Trent £566 million (2017-18 prices) across six Green Recovery projects, supporting both environmental and social ambitions and RCV growth on which the company will earn future economic returns.

# Financial metrics analysis and credit ratings

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The supporting detail is structured as follows:

- Key Metrics Table
- Lowest Monitored Credit Ratings
- Borrowings
- Regulatory Gearing
- Cost of Debt
- Debt Maturity
- FFO to Net Debt
- Adjusted Interest Cover Ratio
- Wholesale Revenue Recovery
- Retail Profit Margin
- Return on Regulatory Equity (RoRE)
- Effective Tax Rate
- Swaps
- Defined Benefit Pension Obligations

# Key financial metrics

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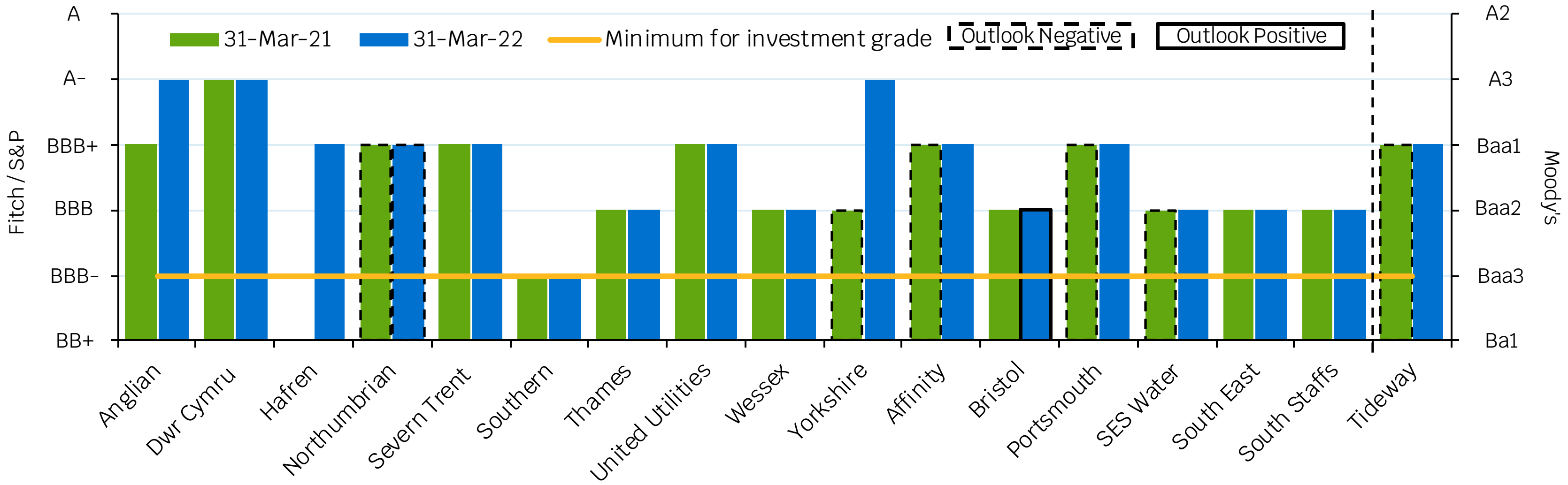
Below is a table of certain key financial metrics for the year ended or as at 31 March 2022. We highlight the metrics provide only static reference points on certain matters within our wider, non-static assessment of resilience and do not represent a grading or ranking of companies by resilience.

| Company (alphabetical) | Regulatory Gearing | Funds From Operations / Net Debt | Adjusted Interest Cover Ratio | Return on Regulated Equity 2021-22 (notional structure) | Dividend Yield | Interest Rate Swaps as a % of RCV | Lowest monitored credit rating and outlook |
|---|---|---|---|---|---|---|---|
| Affinity | 74.0% | 6.8% | 1.36 | 0.8% | 0.0% | 4.6% | Baa1/BBB+ Stable |
| Anglian | 65.4% | 8.6% | 1.36 | 3.7% | 2.7% | 12.7% | A3/A- Stable |
| Bristol | 68.4% | 12.7% | 2.63 | 6.6% | 4.7% | 0.0% | Baa2 Positive |
| Dŵr Cymru | 57.7% | 7.8% | 1.17 | 3.7% | 0.0% | 3.4% | A3/A- Stable |
| Hafren | 39.7% | 14.7% | 0.68 | 6.6% | 0.0% | 0.0% | BBB+ Stable |
| Northumbrian | 69.7% | 6.3% | 0.74 | 2.1% | 13.2% | 1.7% | BBB+ Negative |
| Portsmouth | 73.0% | 6.6% | 1.21 | -1.1% | 10.0% | 0.0% | Baa1 Stable |
| SES Water | 72.4% | 6.4% | 0.19 | 2.0% | 3.5% | 0.0% | Baa2 Stable |
| Severn Trent | 61.9% | 10.8% | 1.96 | 8.8% | 3.8% | 0.4% | Baa1/BBB+ Stable |
| South East | 74.8% | 7.7% | 1.87 | 2.8% | 1.6% | 0.0% | Baa2/BBB Stable |
| South Staffs | 54.1% | 19.1% | 2.73 | 0.0% | 4.4% | 0.0% | Baa2 Stable |
| South West | 63.7% | 10.9% | 2.21 | 9.1% | 6.7% | -0.5% | - |
| Southern | 65.5% | 2.2% | -0.33 | -2.8% | 0.0% | 38.0% | Baa3 Stable |
| Thames | 80.6% | 5.9% | 1.28 | 4.8% | 0.7% | 9.3% | Baa2 Stable |
| United Utilities | 64.8% | 10.9% | 2.42 | 7.8% | 7.7% | -0.4% | BBB+ Stable |
| Wessex | 66.9% | 7.9% | 1.54 | 8.3% | 5.3% | 0.0% | BBB Stable |
| Yorkshire | 72.5% | 7.9% | 1.96 | 1.1% | 2.5% | 32.0% | A- Stable |

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

# Lowest Monitored Credit Rating as at 31 March






The chart presents the lowest rating monitored by Ofwat for licence purposes as at 31 March 2022, alongside outlook.

Credit ratings and outlooks reflect an agency's view of both sector dynamics and the company's specific characteristics and actions. An important part of the regulatory ring-fencing licence conditions is the requirement for companies to maintain an Issuer Credit Rating that is an investment grade rating*.

We expect companies to have headroom against the bottom of investment grade. If one or more of a company's monitored ratings is at the minimum for investment grade (currently BBB-/Baa3) and is 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.

In regard to Yorkshire, following Moody's withdrawal of its corporate family rating, the lowest monitored rating at 31 March 2022 was with S&P (A-, Stable). Going forward Yorkshire's Class A issue rating with Moody's will be monitored, which at Baa2 Stable would have been the company's lowest rating at 31 March 2022.

Hafren's dispensation for maintaining a separate credit rating expired on 31 March 2022 when the company ceased to be a subsidiary of Severn Trent. South West's* dispensation is also due to be removed such that the company will be required to have a credit rating from April 2025 at the latest.

*South West currently has a dispensation from this requirement, however its licence requires the company to annually certify that it would be able to maintain an investment grade credit rating. This was certified as at 31 March 2022.

# Monitored Credit Ratings, post 31 March 2022 rating and/or outlook changes

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| Company | Rating Agency | Credit Rating at 31 March 2022 | Latest Rating/Outlook (revised post year end) | Has this changed the lowest monitored credit rating? |
|---|---|---|---|---|
| Northumbrian | S&P | BBB+, negative | BBB, stable | Yes, 1 notch downgrade |
| Southern | S&P | BBB+, stable | BBB+, negative | No |
| Thames | S&P | BBB+, watch negative | BBB, stable | No |
| Anglian | S&P | A-, stable | A-, negative | Yes, outlook only |
| Affinity | S&P | BBB+, stable | BBB+, negative | Yes, outlook only |
| South East | S&P | BBB, stable | BBB, negative | Yes, outlook only |
| Dŵr Cymru | S&P | A-, stable | A- negative | Yes, outlook only |
| South Staffs | S&P | BBB+, stable | BBB+ negative | No |
| Yorkshire | S&P | A-, stable | A-, negative | No |
| Wessex | Fitch | BBB, stable | On 25 November 2022 Fitch affirmed the company's long-term Issuer Default Rating (IDR) at BBB with Stable Outlook and simultaneously withdrew the rating for commercial reasons. | Yes, the withdrawn rating was the company's lowest monitored credit rating. |

The table sets out the rating and outlook changes that have occurred between 31 March 2022 and report publication in respect to the credit ratings monitored for licence compliance purposes. For some companies this has resulted in a change to their lowest monitored rating reported at 31 March 2022.

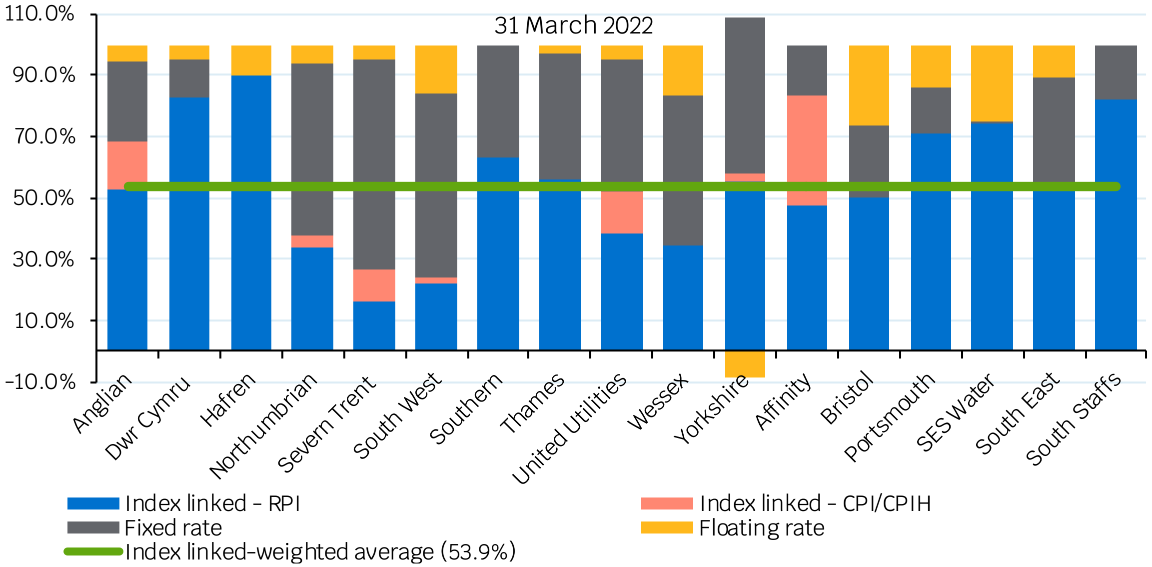
We note a key driver cited for the changes in rating and outlook by S&P is the impact and potential pressure of high inflation in the short term on its credit metric calculations.

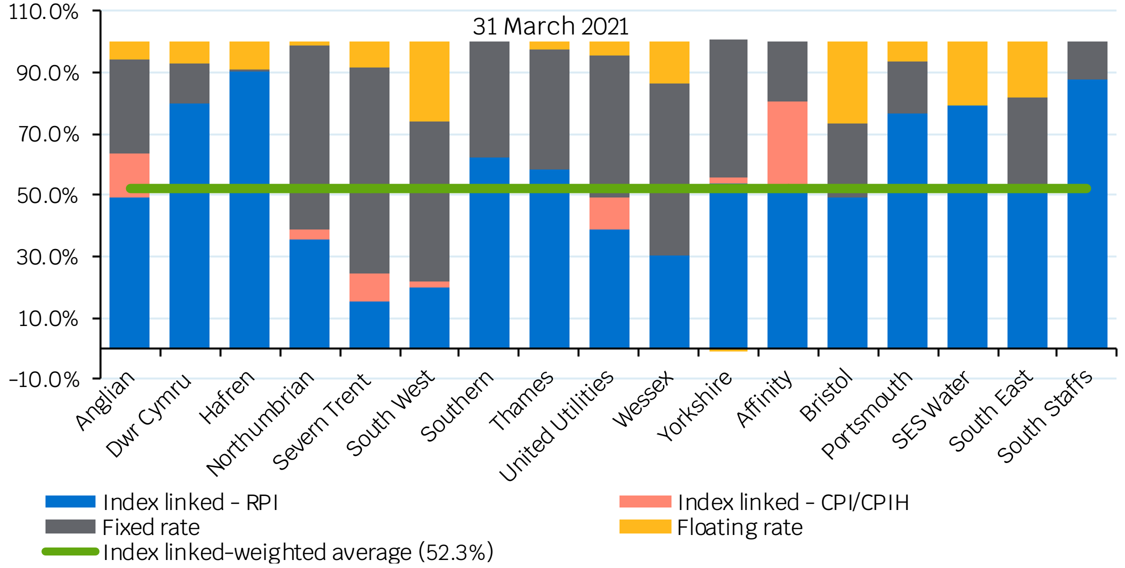
None of the credit rating changes as outlined have resulted in a trigger event under companies' banking covenants as we are aware or have triggered the current licence cash lock-up clause. All companies* at this time continue to maintain at least one issuer credit rating at or above the minimum investment grade as required by licence.

One of the proposals included in our July 2022 statutory consultation is in regard to the cash lock-up clause and whether the trigger level should be reset in order for this protection to be more effective. Our response will be published in the new year.

* In the case of South West who currently has a dispensation, an annual certification that it would be able to maintain an investment grade credit rating as at 31 March 2022 has been provided.

# Borrowings as at 31 March




Total debt in the sector has increased from £59.3 billion at 31 March 2021 to £60.6 billion at 31 March 2022*.

A key driver for the year-on-year increase has been the impact of high inflation on index-linked debt.

The nominal value of index-linked debt generally grows with inflation. With more than 50% of debt in the sector indexed to inflation, and with the vast majority being linked to RPI, the impact as at 31 March 2022 has been material.

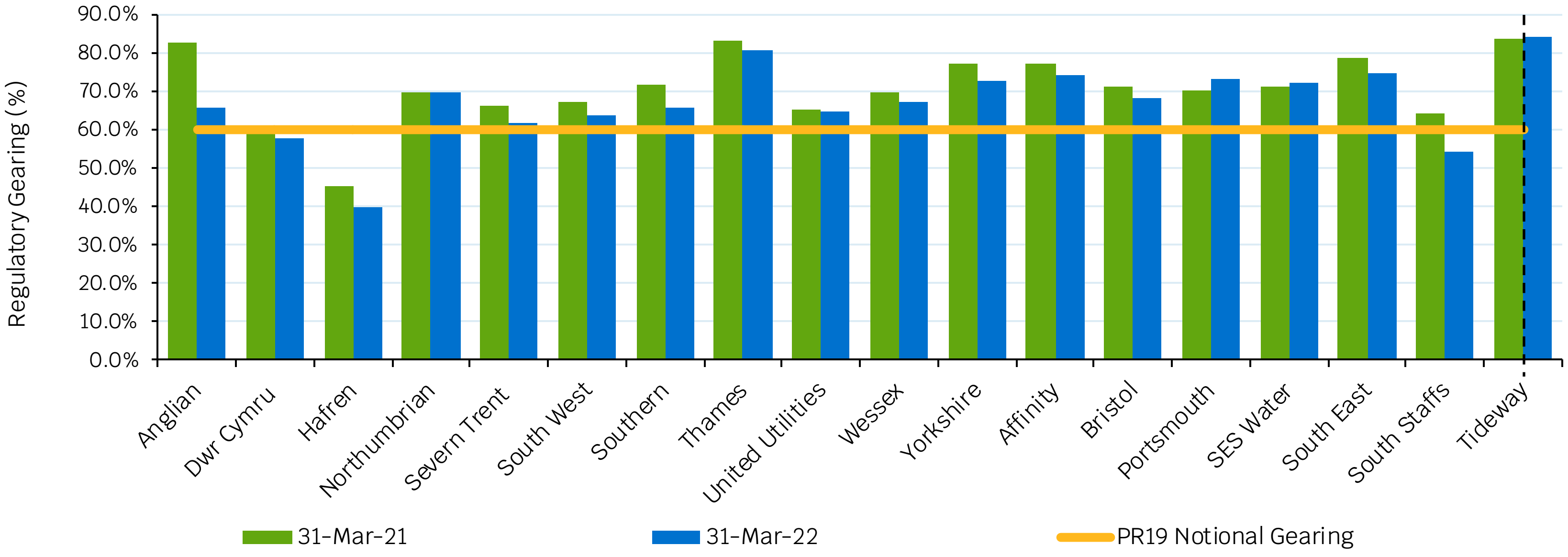
The uplift in debt, and a great deal of the increase in the interest expense reported in companies' income statements, has had a largely non-cash impact in 2021-22. However, in some cases has had a negative impact on companies' credit metrics and ratings.

As at 31 March 2022 Yorkshire reported negative floating rate debt. This is due to the nominal value of a swap from floating rate to index-linked (RPI) debt, which as at 31 March 2022 exceeded the balance of other floating rate debt.

*Excluding Tideway. Net debt has increased from £56.2 billion to £57.6 billion

# Regulatory Gearing as at 31 March






Regulatory gearing measures reported net debt as a proportion of RCV. At PR19, for the notional company we assumed a capital structure whereby 60% of RCV is funded by debt.

Weighted average gearing across for the sector was 68.5% at 31 March 2022 compared to 72.8% prior year (excluding Tideway*). Key drivers for the reduction in gearing are the positive inflationary impact on companies' RCV**and the impact of some large equity injections in 2021-22.

As RCV is indexed to inflation annually, in a high inflation environment gearing typically reduces. Those companies with more inflation-linked debt see less improvement in their regulatory gearing from rising inflation compared to those with higher holdings of fixed-rate debt.

Equity injections in the year at Anglian, Severn Trent and Southern and the repayment of an outstanding intercompany loan at South Staffs has supported their deleveraging.

Except for Portsmouth, SES Water and Northumbrian, all companies reported a reduction in their level of gearing at 31 March 2022. Thames remains the highest geared at 80.6%. Yorkshire, Affinity, Portsmouth, SES and South East all reported a gearing level above 70%.

*In line with the RAGs, Tideway's shareholder loans (£799.5million at 31 March 2022) are included within the borrowings figure used to calculate gearing. All sector references exclude the figures for Tideway.
**50% of companies' RCV at 31 March 2020 is linked to RPI, with the remainder and any new additions linked to CPIH.

# Indicative weighted average nominal interest rate, 2021-22

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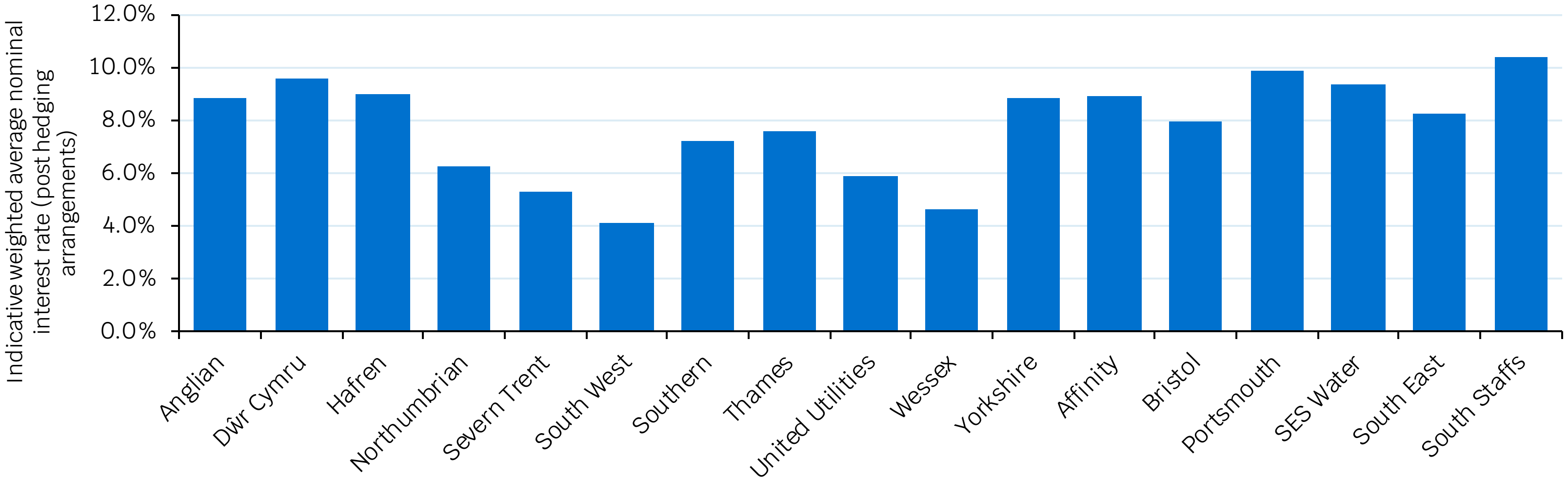



We set a cost of debt allowance at a level allowing an efficient company under our notional financial structure to cover its efficient debt interest costs.

For PR19 our overall allowed return on debt* was 2.14% (real in CPIH terms and 4.18% nominal**), calculated as the weighted average of the cost of embedded debt and new debt (as issued during the price control period and used to finance new RCV and refinance existing debt as it matures).

The chart presents the indicative weighted average nominal interest rate (post hedging arrangements) reported by each company. Companies reported indicative nominal rates have risen in 2021-22 (and are higher than the nominal cost of debt allowance) due to the rapid rise in outturn inflation.

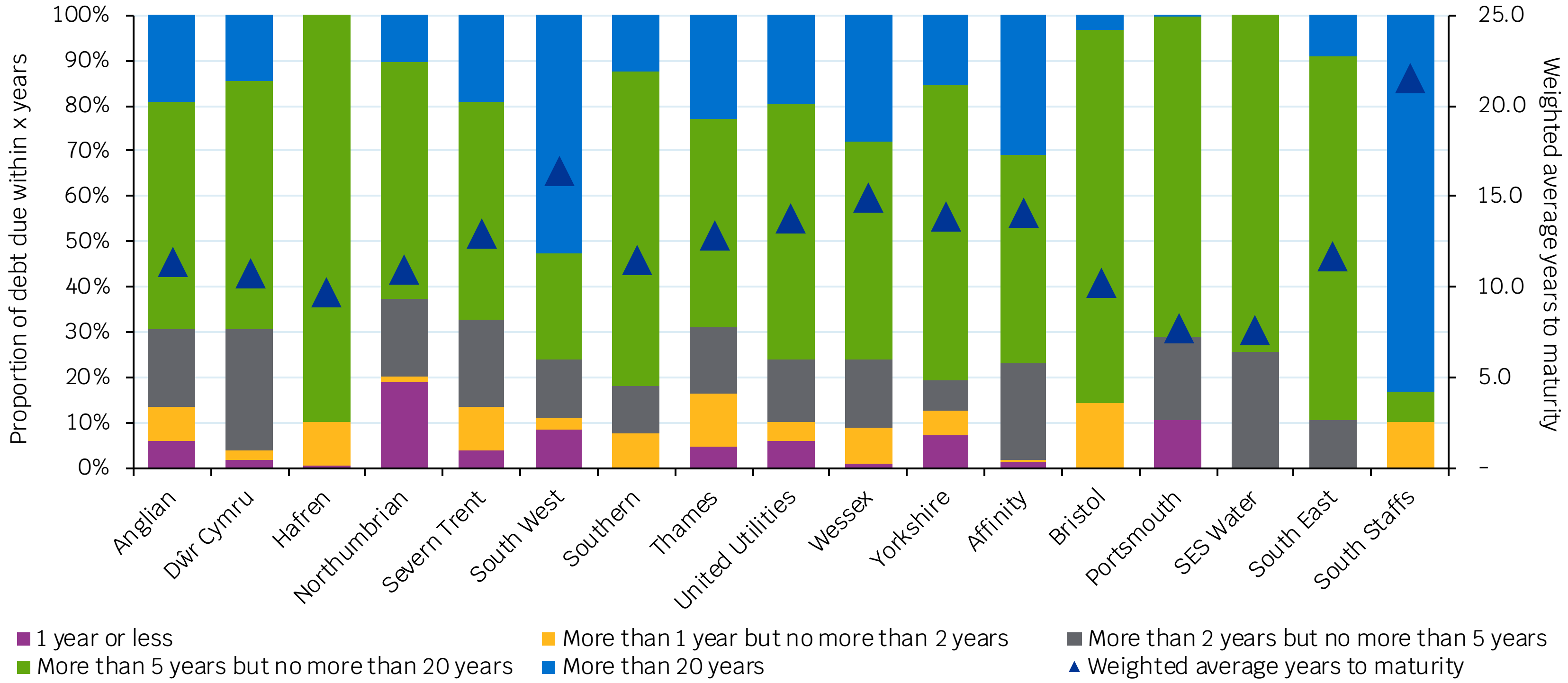
In general, those companies with greater levels of index-linked debt have reported a greater increase in their interest expense in 2021-22. While the increase reflects largely accretion with a non-cash effect i.e., the increase in cash interest rates has been lower, in some cases this has had a notable impact on companies' income statements. It can also impact on certain credit metrics and credit ratings.

Although allowed revenue is indexed to inflation, allowed returns are fixed in real terms for the regulatory period. A true-up mechanism will be applied at PR24 to reflect changes in the market cost of debt, however in the short term, rises in interest rates may increase pressure on interest coverage metrics.

* The allowed cost of debt differs between companies reflecting specific company adjustments and to reflect the CMA's decision for appealing companies. ** Nominal based on our long term inflation assumptions (CPIH 2.0% and RPI 3.0%) [PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf (ofwat.gov.uk).](PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf)

# Debt Maturity as at 31 March 2022






The sector typically holds long-dated debt (simple sector average of approximately 12.5 years as at 31 March 2022).

Refinancing requirements vary between companies depending on their debt maturity profile. Those companies with greater refinancing requirements coming up and/or that have a higher proportion of floating rate debt, will likely be more exposed to the recent rises in interest rates and may face a larger increase in debt service costs.

# FFO/Net Debt as at 31 March

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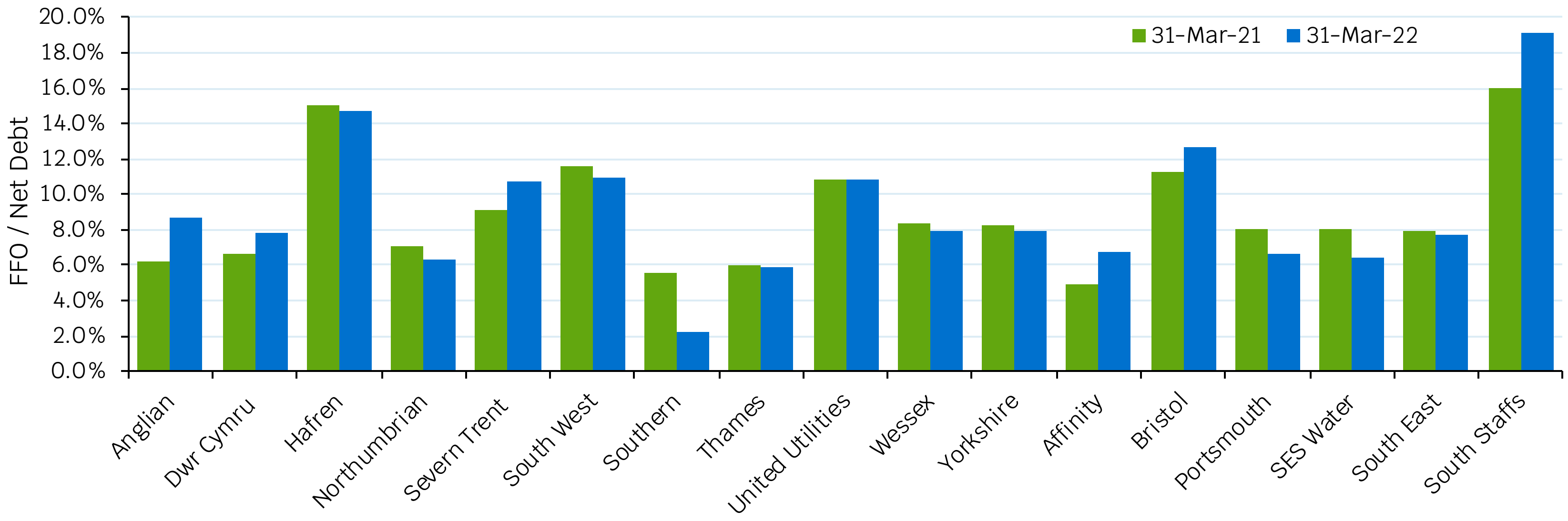



This metric shows the Funds from Operations (FFO), being the net cash generated from operating activities each year excluding changes in working capital, available to meet net debt liabilities.

For the sector as a whole, the metric has remained broadly in line with prior year (8.0% at 31 March 2022 and 7.8% at 31 March 2021). However some companies have reported more notable movements year-on-year.

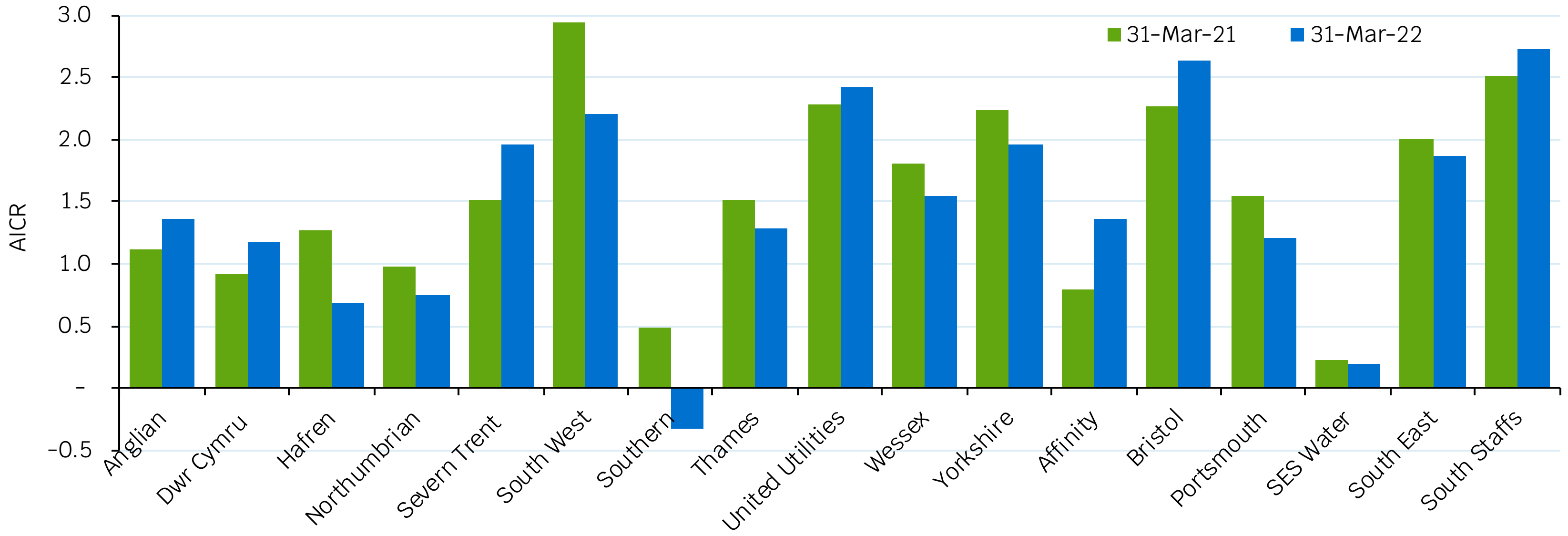
Both Anglian and South Staffs reported a more than 2pp increase in their FFO/Net Debt (to 8.6% and 19.1% respectively), with both companies increasing their FFO alongside reducing net debt.

Southern reported the greatest reduction in (and lowest) FFO/Net Debt (3.4pp reduction to 2.2%) with its EA fine and a large one-off pension deficit reduction payment impacting on its FFO this year.

FFO can be impacted by a range of factors including for example changes in consumer demand, inflation (impacting both revenue and costs), investment and cost profiles, cash collection and taxation, and as such companies will not have the same FFO or FFO/Net Debt metric. As with all metrics we monitor changes over time alongside other relevant information, and in particular where there is a trend of deterioration.

# Adjusted Interest Cover Ratio as at 31 March






The Adjusted Interest Cover Ratio (AICR) measures the FFO available to meet interest, adjusting for regulatory depreciation (RCV run-off). The ratio is calculated by reference to cash interest paid in the period*.

For the sector as a whole, the metric has fallen to 1.41x compared to 1.48x prior year (weighted average).

Southern reported the greatest year on year decline in AICR due predominantly to the reduction in its FFO as noted, followed by Hafren being in large part due to the increase in its RCV run-off, and South West driven by a combination of a higher RCV run-off and a higher interest cost compared to prior year.

Hafren, Northumbrian, Southern and SES Water all reported an AICR of below 1 for the year 31 March 2022 implying that after deducting the allowance for RCV run-off, the cash interest cost for the year could not be met fully from the Funds From Operations in that year. While an AICR of below one in a single year is not necessarily an issue, an AICR that remains below 1 for a persistent period time indicates an increased level of concern.

There are a range of factors that can impact on AICR, some specific to the circumstances of each company. We monitor interest metrics over time and in the round.

* The RCV run off figures are published by Ofwat each year. AICR is a more conservative measure than interest cover. It provides an indication of interest coverage assuming companies cannot reduce the RCV run-off.

# Wholesale Revenue under/(over) recovery, 2021-22

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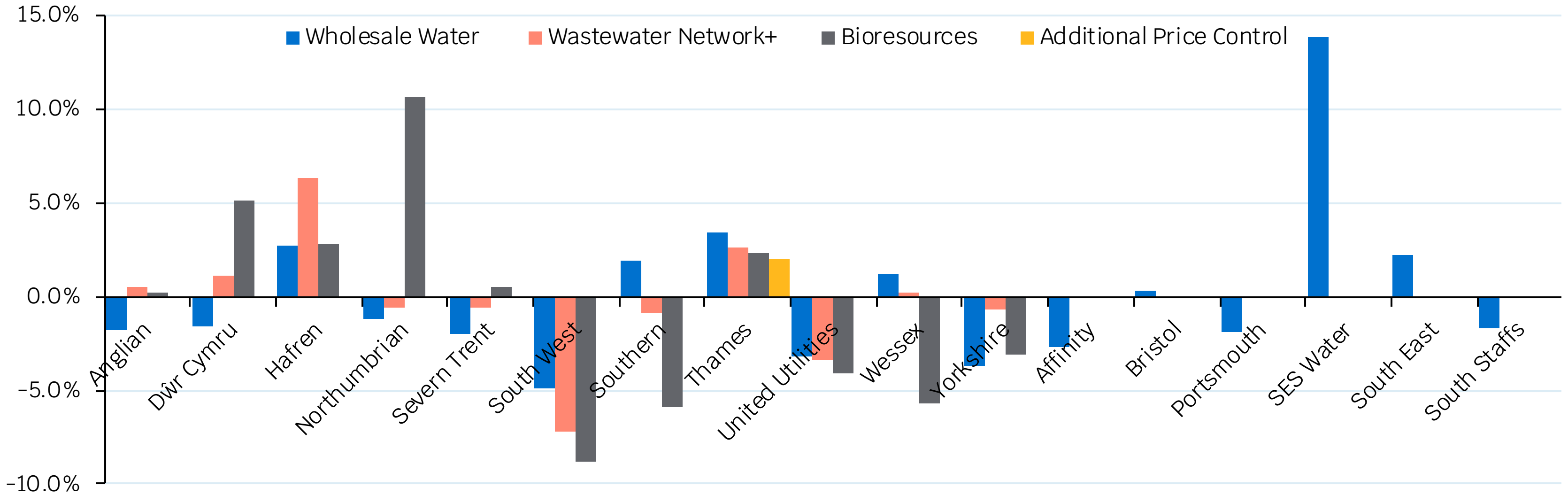


The regulatory regime for UK water companies is based on a revenue allowance approach. Across the industry, total wholesale revenue recovered during 2021-22 was £5,745 million for water and £5,860 million for wastewater, being 0.7% and 0.6% above the total regulatory allowance respectively*.

The ongoing impact of Covid-19 on companies' revenue recovery in 2021-22 has been mixed, noting that forecasts and tariffs for 2021-22 were also set at a time of significant economic uncertainty.

Some companies reported experiencing a stronger than anticipated recovery in commercial demand and developer services, alongside a higher than expected residential demand with the continuation of home working, in particular South West, United Utilities and Yorkshire. Other companies including Hafren, Thames and SES Water, experienced lower than forecast consumption volumes and new connections.

Under the revenue forecasting incentive (RFI) companies can recover under-collected or will repay over-collected revenue (with a two-year delay)**. Where the difference between actual and allowed revenues is greater than 2%, companies incur a financial penalty. The RFI helps companies to manage revenue and provides incentive to minimise bill volatility. However, recognising in the meantime an under recovery may place pressure on certain financial metrics.

* Difference between total revenue governed by wholesale price control and the revenue cap (allowed wholesale revenue, grants and contributions plus adjustments), totals referenced exclude additional price control.
**The RFI does not apply to the Bioresources control. Companies may choose to spread the effect of large revenue adjustments over several future years to avoid significant fluctuation in bills from year to year.

# Retail Profit Margin, 2021-22

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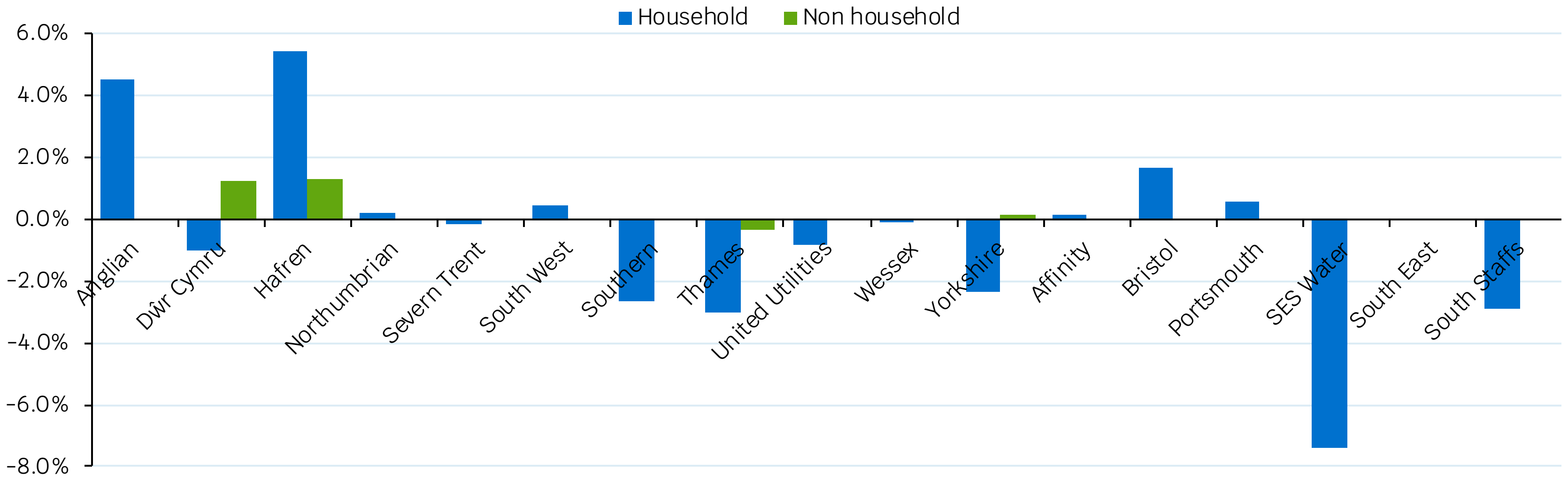



The overall sector household retail margin for 2021-22 was -0.72% (-1.61% 2020-21 ) compared with an assumed net retail margin cap of 1%*. Several companies reported a loss across their retail business, for reasons including:

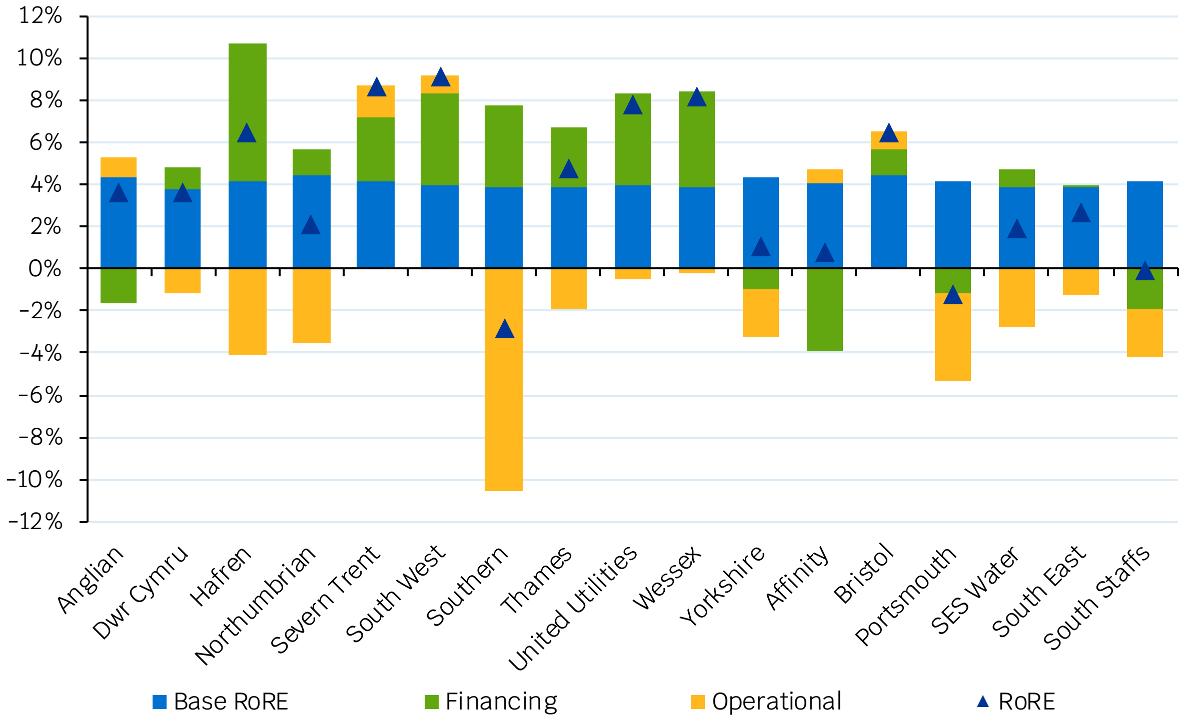
- While most companies reported an improved or better than expected cash collection during 2021-22, bad debt provisioning remained higher than originally envisaged due to the ongoing impact of COVID-19 and the cost of living challenges depressing margins.
- Further investment in customer services and debt collection activities, and in order to catch up from Covid-19.
- Inflationary pressure on input costs such as postage, whilst the retail cost allowance does not increase with inflation.
- A reduction in revenue for some companies with a higher number of customers supported through social tariffs than had been expected.

SES Water was also specifically impacted by the costs associated with implementation of a new billing system.

Hafren has attributed its margin and general retail outperformance to efficiencies made in customer services and debt management costs relative to the FD allowance, and Anglian to a reduction in its bad debt charge and lower take-up of its social tariff for the year as a whole, compared to forecast.
We note all companies are expecting the cost of living challenges to impact on retail debt recovery and margins in 2022-23.

*The non-household retail market opened to competition in April 2017, following which all companies except for Hafren, Dŵr Cymruand South West exited the non-household retail market.

# RoRE – Returns on notional regulatory equity, 2021-22




| Source of RoRE Variance | High | Low | Simple average 2021-22 | Simple average AMP to date |
|---|---|---|---|---|
| Base | 4.44% | 3.81% | **4.08%** | **4.07%** |
| Financing adjustments | 6.51% | -3.94% | 1.45% | 0.58% |
| Operational performance adjustments | 1.58% | -10.59% | -1.75% | -1.60% |
| | | | | |
| RoRE | 9.15% | -2.81% | **3.78%** | **3.05%** |

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* (Base return), 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 2021-22 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. Alongside the average for the year, is the average for the AMP to date.

For 2021-22, 7 companies reported a RoRE above their Base return with South West the highest at 9.15%. South Staffs, Portsmouth and Southern reported a negative RoRE.

Additional commentary is set out on the following pages.

* 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, 2021-22

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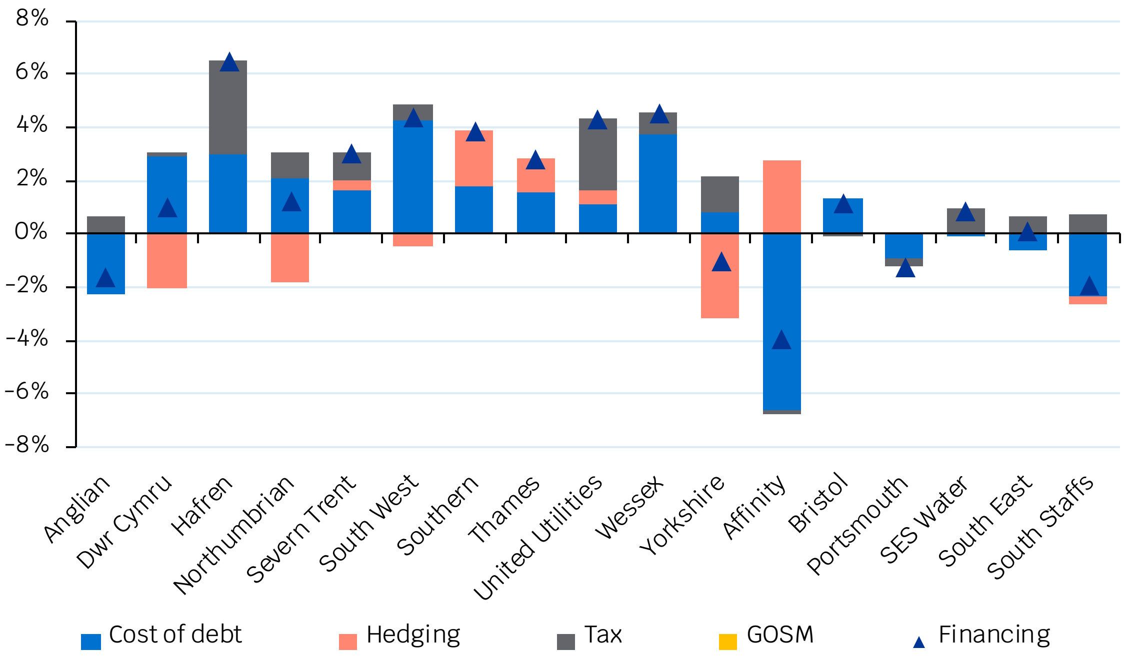



| Source of RoRE Variance | High | Low | Simple average 2021-22 |
|---|---|---|---|
| Cost of debt | 4.24% | -6.57% | 0.68% |
| Hedging instruments | 2.79% | -3.18% | -0.04% |
| Variance in corporation tax | 3.51% | -0.29% | 0.81% |
| Gearing benefits sharing | 0.00% | 0.00% | 0.00% |
| | | | |
| Financing adjustments | 6.51% | -3.94% | **1.45%** |

**Cost of debt and hedging:** Cost of debt is considered in real terms with companies comparing their cost of debt adjusted for outturn inflation (CPIH) to the cost of debt allowance.

Due to CPIH being higher than assumed, the majority of companies reported outperformance on real cost of debt. South West reported the greatest outperformance.

Five companies reported an underperformance indicating their actual cost of debt was higher than the real rate assumed for PR19, in particular Affinity and South Staffs.

Several companies use hedging instruments to manage their debt cost. For some the impact of these arrangements has been to increase their cost of debt in the year.

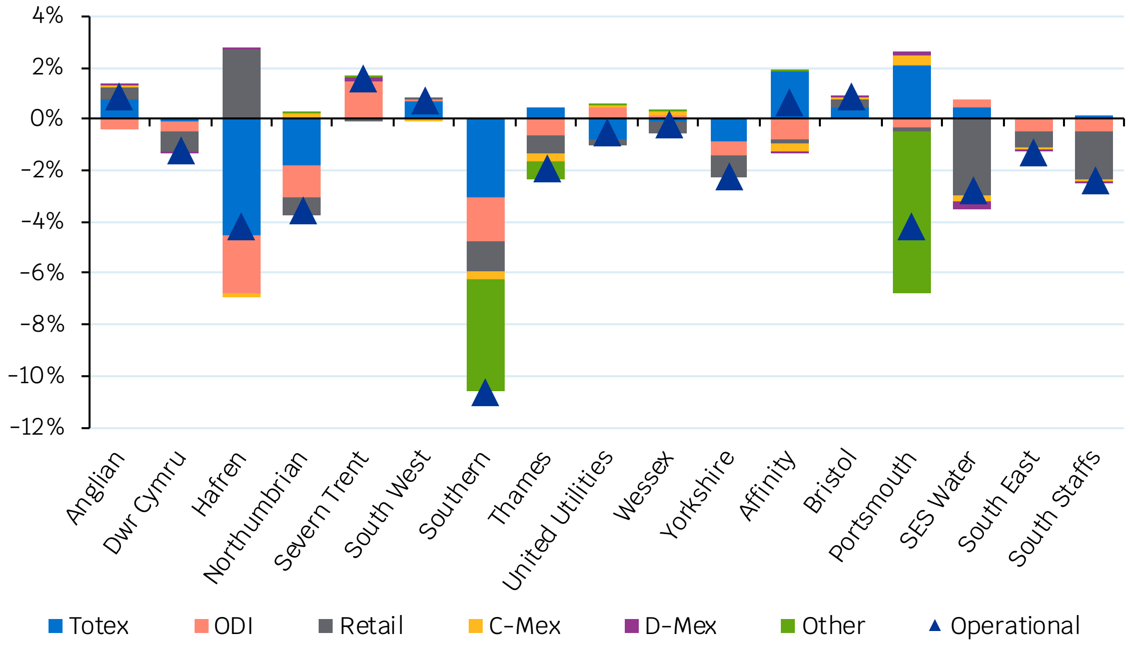
Tax: Nearly all companies reported outperformance with tax payable being less than tax funded in their FD.

Outperformance has been driven by a range of factors including lower than assumed taxable profits and variation in capital allowances (with super deductions and accelerated expenditure).

**Gearing outperformance sharing mechanism:** Due to high inflation, outturn cost of debt for 2021-22 was for many companies greater than the allowed cost of equity, in nominal terms. Consequently, where it applies, the GOSM, which is designed to allow customers to share in the returns equity investors achieve from high gearing, has not been triggered and is reported as nil this year.

# RoRE – Operational out/(under) performance, 2021-22






| Source of RoRE Variance | High | Low | Simple average 2021-22 |
|---|---|---|---|
| Totex out / (under) performance | 2.07% | -4.53% | -0.26% |
| ODI out / (under) performance | 1.42% | -2.29% | -0.40% |
| Retail out / (under) performance | 2.68% | -3.00% | -0.43% |
| C-Mex out / (under) performance | 0.43% | -0.30% | -0.02% |
| D-Mex out / (under) performance | 0.15% | -0.30% | 0.00% |
| Other exceptional items | 0.12% | -6.30% | -0.64% |
| | | | |
| Operational performance total | 1.58% | -10.59% | **-1.75%** |

**Totex*:** We set the allowance on what companies can spend on producing water and wastewater services over the AMP. Companies performance against their total expenditure allowance in 2021-22 is set out in the Water Company Performance Report.

The impact on RoRE of companies overspend or underspend against their allowance (which can be for a range of reasons, with some of the difference recovered from or returned to customers), has been mixed.

In the year, eight companies reported overspend due to factors such as higher than assumed energy costs and bulk supply costs, and increased spending to improve performance against outcome delivery targets.

Nine companies reported underspend, namely Portsmouth reflecting efficiencies on operating costs and Affinity explained as being due to underspend on its strategic regional water resources expenditure.

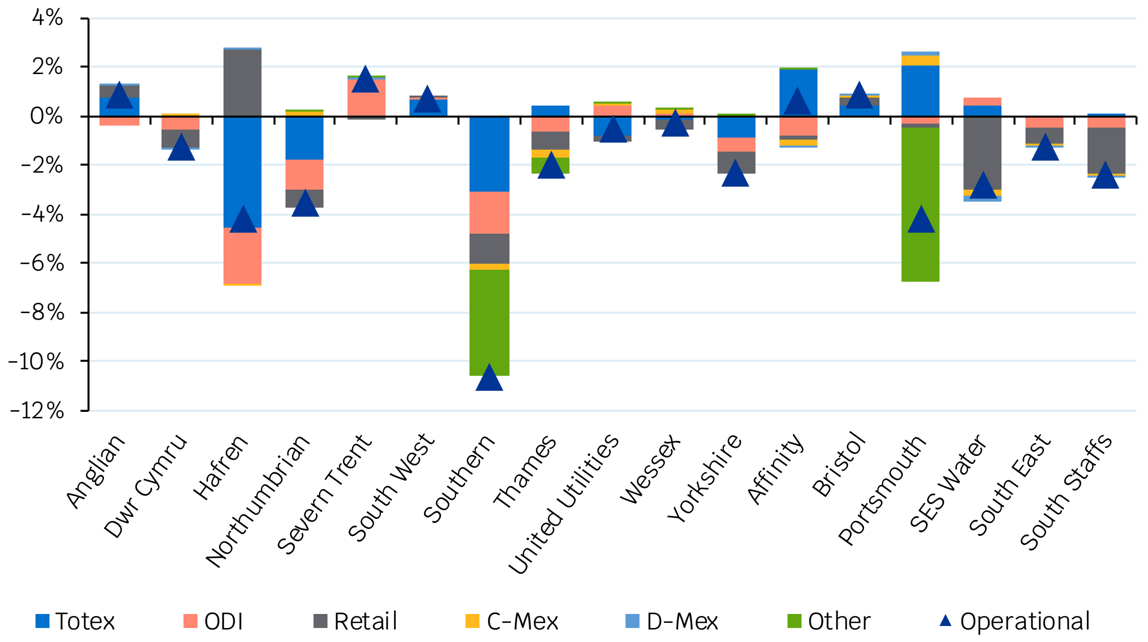
**Outcome delivery incentives (ODIs):** Companies can earn rewards or penalties for performance against ODIs, which reflect service performance commitments agreed with customers. The Water Company Performance Report also sets out performance for a set of key performance and expenditure metrics.

The actual reward or penalty that companies receive may differ to that reported following Ofwat's 2021-22 in-period ODI assessment process**.

* Totex out/underperformance is calculated after adjusting for timing differences and the company sharing ratio with customers.
** On 15 November 2022, we published our final determinations confirming the payments due to companies or customers as a result of water company performance against their 2021-22 performance commitments. Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22

# RoRE – Operational out/(under) performance, 2021-22 (continued)

▲ Contents




| Source of RoRE Variance | High | Low | Simple average 2021-22 |
|---|---|---|---|
| Totex out / (under) performance | 2.07% | -4.53% | -0.26% |
| ODI out / (under) performance | 1.42% | -2.29% | -0.40% |
| Retail out / (under) performance | 2.68% | -3.00% | -0.43% |
| C-Mex out / (under) performance | 0.43% | -0.30% | -0.02% |
| D-Mex out / (under) performance | 0.15% | -0.30% | 0.00% |
| Other exceptional items | 0.12% | -6.30% | -0.64% |
| | | | |
| Operational performance total | 1.58% | -10.59% | **-1.75%** |

**Retail:** Retail activities include the provision of customer services, managing bad debt and meter readings. We set separate price controls for companies' residential retail activities, and there is no automatic indexation of allowed revenue within the price control period.

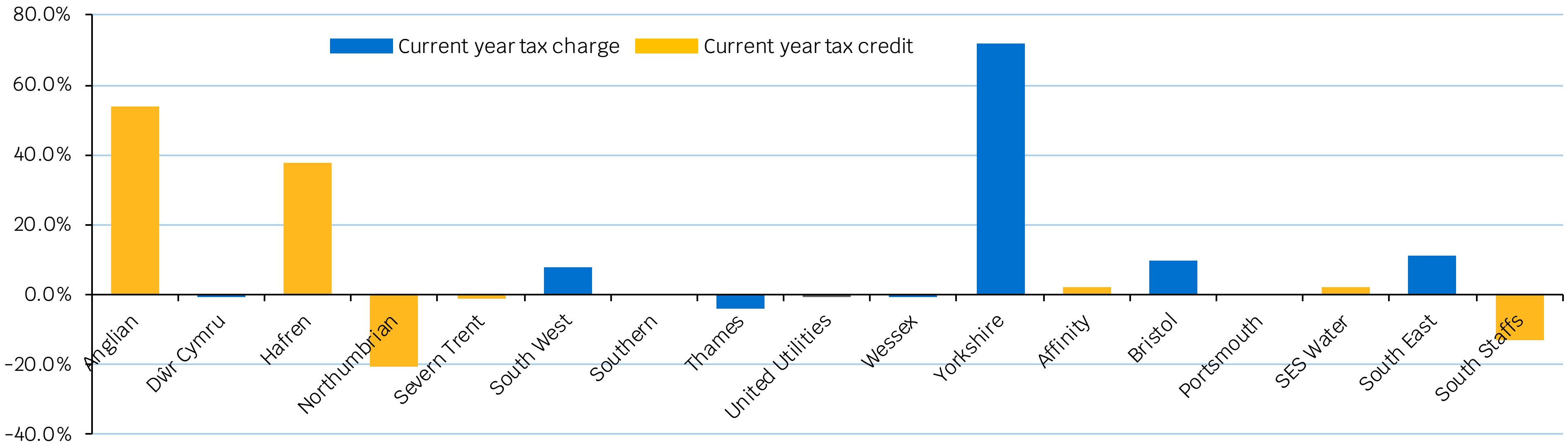
For 2021-22 nearly all companies spent in line with or in excess of their retail allowance. Whilst most companies reported better than expected cash collection rates, for many bad debt provisioning remains higher than FD assumptions reflecting largely the rise in cost of living and anticipated challenges this presents for affordability.

Performance at SES Water and South Staffs was impacted by higher costs associated with the implementation of a new billing system and revised reporting requirements on software respectively.

Hafren and Anglian both reported underspend for reasons including efficiencies made in customer services and debt management costs and a reduction in bad debt charge.

**C-Mex and D-Mex:** These are customer / developer measures of experience introduced in AMP7. Data collected from the companies is used to calculate rewards or penalties based on the relative performance. The impact for 2021-22 relates to performance in 2020-21 (1 year lag).

**Other:** This reflects exceptional items impacting returns. For Southern this is the impact on returns of the fine and associated court and legal costs of the prosecution by the EA, and for Portsmouth the impact from a large debt restructuring fee.




Effective tax rate is the current tax charge/credit recognised in the accounts of the appointed business as a percentage of the profit/loss (before tax and fair value movements) for the appointed business.

For 2021-22, nine companies reported a current year tax credit. This year, companies in general reported tax losses or lower taxable income due to factors including:

- Tax reliefs in excess of depreciation charged in the accounts, including a new first-year super-deduction capital allowance which was introduced in the Finance Act 2021 to encourage and support UK investment*.
- The availability of tax relief on pension contributions paid in the year.
- Some income not being taxable.
- Lower profits.

Tax credits can also reflect receipts from other group companies for losses surrendered.

In addition to the current year tax, several companies reported a material one-off charge to their income statement as a result of restating their deferred tax liability using the future UK corporation tax rate as set out in the Finance Act 2021 (from 19% to 25% effective 1 April 2023). Any changes to that rate will be reflected in 2022-23 financial accounts.

* HM Treasury, from 1 April 2021 until 31 March 2023 companies can claim a new 130% first-year capital allowance for qualifying plant and machinery assets and a 50% first-year allowance for qualifying special rate assets.
Where corporation tax or capital allowance differs to our assumptions, companies and customers are protected through adjustments made at the next price review in accordance with the tax reconciliation mechanism.

# Financial Derivatives – Interest Rate Swaps

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| Company | Interest Rate Swaps £million at 31 March 2022 | % of RCV at 31 March 2022 | % of RCV at 31 March 2021 |
|---|---|---|---|
| Anglian | -1,107.8 | 12.7% | 10.9% |
| Dŵr Cymru | -221.2 | 3.4% | 4.5% |
| Hafren | - | 0.0% | 0.0% |
| Northumbrian | -78.1 | 1.7% | 1.3% |
| Severn Trent | -37.7 | 0.4% | 0.9% |
| South West | 18.8 | -0.5% | 0.6% |
| Southern | -2,143.3 | 38.0% | 28.0% |
| Thames | -1,542.3 | 9.3% | 6.7% |
| United Utilities | 52.6 | -0.4% | -1.0% |
| Wessex | - | 0.0% | 0.0% |
| Yorkshire | -2,479.5 | 32.0% | 30.8% |
| Affinity | -68.0 | 4.6% | 3.7% |
| Bristol | - | 0.0% | 0.0% |
| Portsmouth | - | 0.0% | 0.0% |
| SES Water | - | 0.0% | 0.0% |
| South East | - | 0.0% | 0.0% |
| South Staffs | -0.1 | 0.0% | 0.6% |

Table reflects mark to market values reported in Table 4I, unless the company has reported a different fair value amount.

Cells highlighted in green reflect in the money/asset positions.
Cells highlighted in grey where swap MTM liability is greater than 5% of RCV.

Most companies use financial instruments to manage their exposure to market conditions, including raising inflation linked debt and using derivatives, namely swaps.

As financial instruments are typically valued at yearend based on the current market expectations of future interest, inflation and exchange rates, the value of these instruments can fluctuate materially with movements in financial markets and create volatility.

With both RCV and revenue linked to inflation, several companies have inflation linked swap portfolios, under which typically a floating or fixed interest rate is swapped to a rate linked to inflation. An out-of-the-money (liability) position arises where the net present value of the future expected payments under the swap is greater than the receipts. Higher inflation expectations have resulted in increased liabilities at year end.

The table opposite presents the fair value of the net interest rate swap liability or asset at the 31 March 2022 and as calculated as a percentage of RCV.

Whilst balances change over time and do not necessarily reflect future repayment, material liabilities can impact on financial resilience as they can affect credit metrics and ratings, and depending on the arrangement can require the company to pay down some indexation accretion ahead of maturity.

# Defined benefit pension schemes at 31 March 2022

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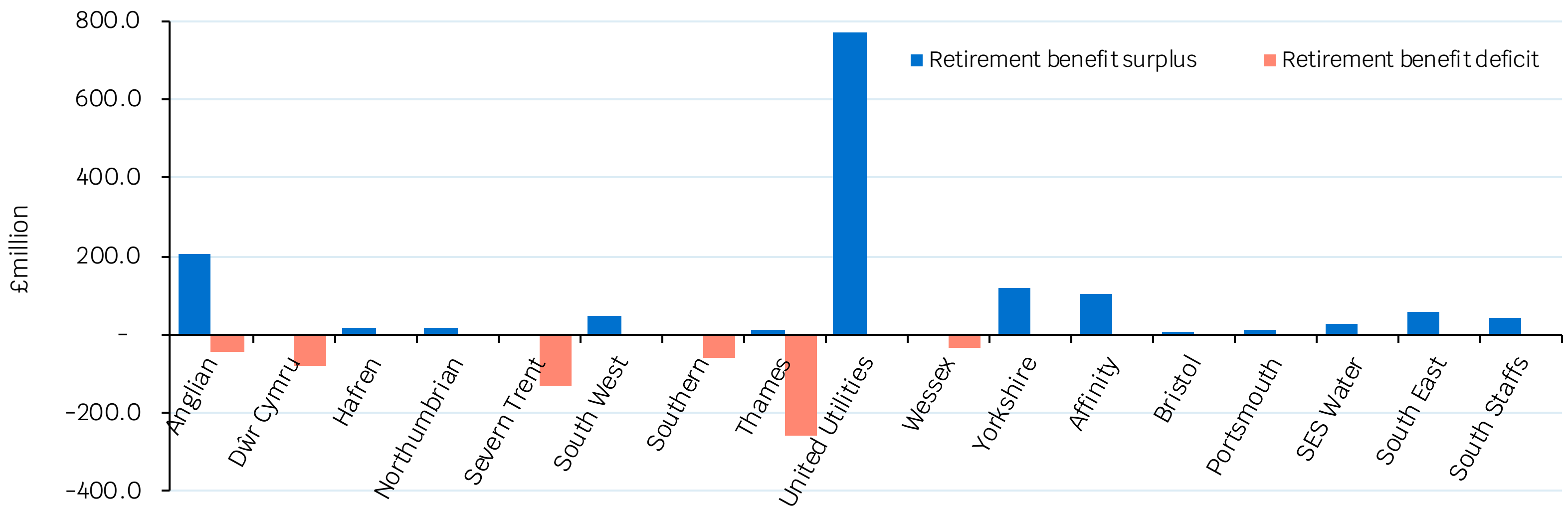


| Deficit repair payments* 2021-22, £ million | |
|---|---|
| Southern | 77.3 |
| Severn Trent | 58.1 |
| Northumbrian | 20.0 |
| Wessex | 15.5 |
| Anglian | 14.6 |
| Yorkshire | 13.9 |
| South East | 4.9 |

All companies in the sector support one or more defined benefit pension schemes. As at 31 March 2022, most companies reported a year-on-year improvement in their pension positions on a accounting basis i.e., a lower deficit and/or a greater surplus.

Improvement in reported positions has been driven mostly by movements in market conditions. Higher bond yields have generally resulted in lower levels of liabilities (partially offset by a higher inflation assumption), and for some schemes returns on their asset portfolios have also been higher this year.

Exceptions are Thames, Bristol and Portsmouth who reported an overall deterioration in their accounting pension positions, driven by factors including adverse changes in their financial and demographic assumptions over the year and lower asset returns.

A scheme's liabilities can be calculated using different methods, which can produce different results that are used for different purposes. The accounting valuation as reported may differ to the valuation that drives a company's funding commitment which is typically carried out every three years.

If on this scheme specific funding valuation the scheme is in deficit, a recovery plan must put in place to repair that shortfall which often involves the company paying an additional cash contribution. Deficit contributions paid in 2021-22 are set out above. This year Southern paid an additional one-off lump sum deficit contribution of £59.6 million.

* Thames made a repair payment of £69.7 million in March 2021 covering the financial periods from 2021-22 to 2024-25. Dŵr Cymru paid £12 million in 2019-20 to remove its funding deficit at that time.

## Assessment summary

## Dividends paid, policies and reporting

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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. Where a company must finance material growth of the asset base or where action may be required to strengthen long term financial resilience, it may need to reduce this base dividend or investors may need to invest more equity.

Dividend yields for 2021-22, alongside the prior year, are set out on the following slide. Overall, the number of companies that declared and paid a dividend in 2021-22 has risen compared to the prior year when several companies determined to either not pay or defer dividends due to the economic uncertainty driven by Covid-19. At the same time, some companies continue to show dividend restraint.

At PR19, following consultation, we set out our expectations for a reasonable dividend policy, including factors we expected companies to consider 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'.

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 final determination, employee interests, pension obligations, financial resilience and the need to finance future investment.

In 2020-21 we reviewed company dividend policies and narrative published in APRs and were disappointed that the disclosures did not provide sufficient transparency for stakeholders. Nearly all companies failed to provide sufficient detail to explain how dividend payments took account of delivery for customers.

2021-22 was the second year that the 2020-25 dividend policies have been applied. We have again carried out an assessment of the disclosures made by companies in their 2021-22 APRs, largely focussing on two key 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.

In explaining dividend decisions and payments, we expect companies to clearly set out how they have taken into account service delivered to customers and commitments, alongside the need for investment to support a turnaround of any poor performance and their long-term financial resilience. This is particularly important where companies have paid a dividend that means the yield in that year is above the base dividend set in our final determination.

# Dividend Yield

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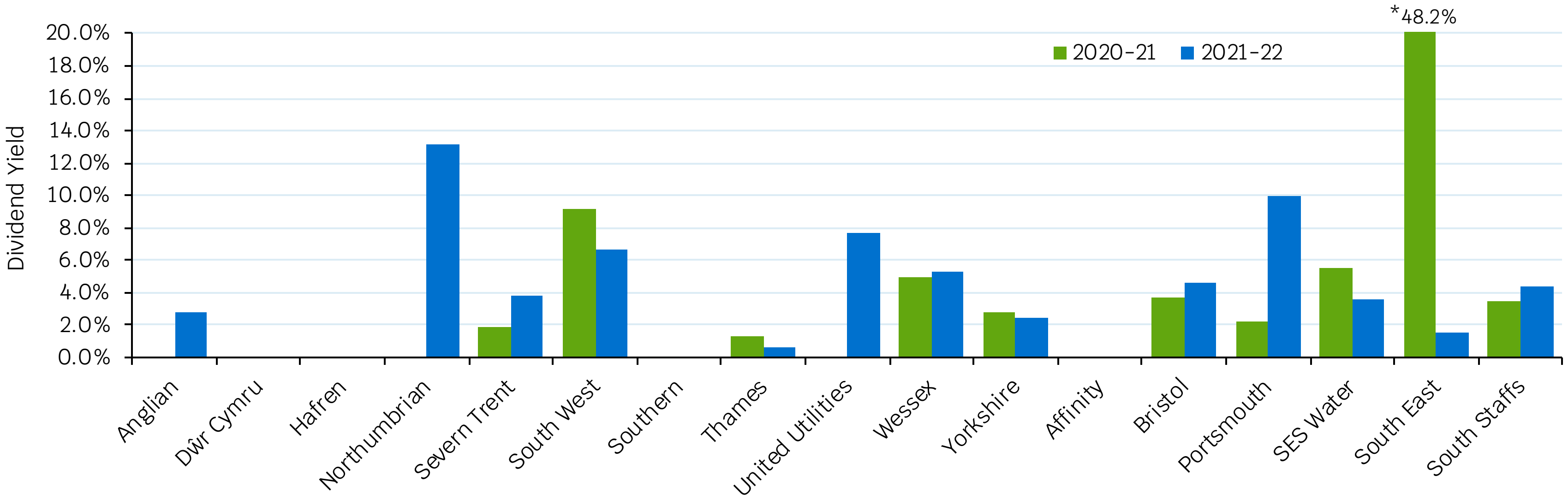


The total dividend declared across the sector in 2021-22 was £1,000.8 million (2020-21 £449.4 million) and the weighted average dividend yield on that basis was 3.8% (2020-21, 1.5% excluding the one-off intercompany loan repayment made by South East*).

Northumbrian returned the highest dividend yield in 2021-22 at 13.2% followed by Portsmouth at 10.0%. In both instances, dividends paid have been reported as relating to performance over a number of years, however neither company met our expectations in regard to clearly explaining how dividends paid had taken into account performance and commitments, alongside wider financial resilience.

Several companies, including Thames and Yorkshire, reported that dividends paid were used, fully or in part, to service wider group debt and head office costs.

*South East paid a special dividend in 2020-21 of £136million which was used by a group company to repay an intercompany loan due to South East. Excluding this repayment the dividend yield for 2020-21 would have been c2.5%.

# Our assessment of dividend policies and their application

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## 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. In most cases companies made reference in their policies to the key factors as set out in the RAGs.

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

Our assessment of 2022 APRs concludes that some companies still need to be clearer about how decisions on dividends declared or paid take account of delivery for customers and the environment. The disclosures do not provide sufficient transparency for stakeholders in this regard mainly for the following reasons:

- Three companies (Anglian, Northumbrian and SES Water) stated that they had taken delivery for customers into account and/or referred an increase or decrease in the amount of dividend paid to reflect performance but provided no explanation of how the adjustment had been calculated or set out what performance was being considered.

- Four companies (Severn Trent, South West, Portsmouth and South Staffs) stated they paid outperformance dividends based on totex or financing outperformance but the narrative didn't explain in sufficient detail how they performed against FD expectations more widely or demonstrate that it was appropriate and prudent to pay out these elements of outperformance. In our draft PR24 methodology, we confirm our expectation that benefits that accrue to equity that are not linked to operational performance, such as the consequences of high inflation on fixed rate debt should be retained or reinvested by the company and not distributed as outperformance. Where outperformance has arisen due to early recovery of revenue to meet longer term commitments, companies should consider retaining rewards for outperformance to meet those future commitments.

- Three companies (Bristol, Portsmouth and South Staffs) explained their dividends by reference to the base dividend yield expectation set out at FD but the dividend calculation suggested that dividends paid to fund interest on intercompany loans were not included in the calculation of base dividend. We have been clear that our expectation of a reasonable base dividend yield includes any intercompany dividends.

# Summary of our assessment for 2021-22

| Company | RCV growth over 2020-25 (FD) | Reported dividend yield on actual equity 2020-21 | Reported dividend yield on actual equity 2021-22 | The company has generally met our current expectations on dividend policy and its application |
|---|---|---|---|---|
| Affinity | 24.8% | 0.0% | 0.0% | ✓* |
| Dŵr Cymru | 2.8% | 0.0% | 0.0% | ✓* |
| Hafren | 35.9% | 0.0% | 0.0% | ✓* |
| South East | 3.1% | 48.2% | 1.6% | ✓ |
| Southern | 10.7% | 0.1% | 0.0% | ✓* |
| Thames | 11.5% | 1.3% | 0.7% | ✓ |
| United Utilities | (4.5%) | 0.0% | 7.7% | ✓ |
| Yorkshire | 5.7% | 2.8% | 2.5% | ✓ |
| Northumbrian | 6.5% | 0.0% | 13.2% | × |
| Portsmouth | 12.1% | 2.2% | 10.0% | × |
| South West | 0.4% | 9.1% | 6.7% | × |
| Wessex | 10.6% | 5.0% | 5.3% | × |
| Bristol | (2.3%) | 3.7% | 4.7% | × |
| South Staffs | 15.1% | 3.5% | 4.4% | × |
| Severn Trent | 3.8% | 1.8% | 3.8% | × |
| SES Water | 7.6% | 5.5% | 3.5% | × |
| Anglian | 9.5% | 0.0% | 2.7% | × |

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.

For 2021-22 companies who generally met current expectations are ordered alphabetically, and companies who did not meet our expectations are ordered by dividend yield.

Four companies, Dŵr Cymru, Hafren, Southern and Affinity, did not pay a dividend in 2021-22 and so did not have to explain their dividends by reference to their performance (✓*). Going forward we expect that when dividends are paid, the APR narrative should explain how dividends paid take account of delivery for customers and the environment.

Thames, United Utilities, Yorkshire and South East paid a dividend in the year and provided narrative on the considerations around the decision on dividends paid. They attempted to set out and quantify how the service delivered for customers in 2021-22 and/or earlier years and other considerations impacted on dividend paid in 2021-22.

Northumbrian Water and Portsmouth Water reported a dividend yield of 10% or higher. They have not adequately set out and explained how the dividend paid in 2021-22 takes account of the service delivered for customers.

## Next steps

We are addressing our assessment findings and overall concerns around how dividend payments take account of performance delivery for customers, and companies' transparency on this, namely through:

- **Strengthening our expectation** across the sector by seeking to update companies' licence condition on dividend policies and payments to include performance as an explicit consideration.
- **Providing feedback and challenge** to all companies, particularly those who have not met our expectations and where dividends above the base allowance *have been paid but not clearly explained. **Companies will be expected to explain how they are addressing feedback points raised.**
- **Reflecting on our findings in our wider assessment of financial resilience**, which may increase monitoring and engagement priority and require action to address, and potentially intervention.

Assessment summary

# Long term viability statements

# Long Term Viability Statements, 2021-22

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All companies are required to provide a statement on their long term viability (the LTVS) either in their APRs or Annual Reports. The LTVS is a key piece of information, and it is important that disclosures are clear and specific to each company.

We consider the quality and transparency of each company's LTVS in a number of areas based on our expectations as set out in IN 19/07, reporting requirements and recognised good practice*.

Our expectation is for companies to provide a LTVS that is sufficiently transparent and detailed to allow the reader to understand the basis on which the Board has reached its conclusions, and that evidences the company has carried out a robust assessment through stress testing its resilience to those risks that could threaten its viability.

Our assessment of the quality of each company's disclosures, and commentary in this report, is not intended to provide any assurance or confirmation of the viability or going concern of the companies.

For 2021-22 all companies provided a LTVS covering at least a seven-year period and we have seen some improvement in the transparency and detail reported this year.

However, few companies met our expectations in all respects and there remains variation in companies' statements in some areas, namely in regard to explaining the stress testing carried out, the impact and results of that testing alongside the available mitigation. We would like to see greater consistency in these areas, recognising that the level of detail will be relative to the findings and taking into account commercial sensitivities.

All companies will be given feedback on their LTVS for 2021-22. The companies where we identified scope for improvement in the aforementioned areas in particular are Bristol, SES Water, Thames, Wessex and Yorkshire.

As with dividend policies and reporting, we reflect on our findings in our wider assessment of companies' financial resilience, which may increase monitoring and engagement priority and require action to address.

* For example, the FRC's report 'Thematic Review, Viability and Going Concern', September 2021 and the UK Government's recent consultation and response in the area of 'Restoring trust in audit and corporate governance'.

We expect each LTVS to be clear and transparent across a number of areas, including the following:

**Period and basis of assessment** – We expect companies to provide clear justification as to why the assessment period chosen is appropriate, noting that the aim of the LTVS is to give the reader confidence that the Board is reflecting on long-term threats to the company.

All companies set an assessment period of at least 7-years, which was positive, however some were better than others at explaining the appropriateness of their assessment period, for instance in reference to the corporate planning processes and planning periods, the nature of their business and investment commitments.

An area for general improvement is companies' explanation upfront of the financial base case that has been tested.

**Processes for risk identification and overall risk assessment** – Either in the body of the LTVS or annual reports, companies should set out their processes and procedures for identifying, assessing and monitoring risk. We expect companies to clearly disclose the range of risks facing their business, their assessment of those risks, and in particular the principal risks identified that could threaten the viability of the company.

We found most companies met our expectations in this area with a detailed account of how risk is identified, measured and managed. This area was generally well sign posted in the LTVS.

**Risk scenarios** – Companies are expected to develop severe but plausible reasonable risk scenarios that are used to test their base case. The scenarios should be clear and reflect the principal risks facing the business as identified and set out. We expect companies to also include one or more combined scenario that covers multiple risks and to clearly state how the scenario combinations have been developed.

All companies included a range of scenarios for testing, including at least one in combination, however there was variation in companies' explanation of those scenarios. The better disclosures were from companies that had clearly set out the scenario developed, including a description, why it was considered severe but plausible and how the scenario mapped to the principle risks identified.

**Stress Testing** – Companies stress test their base case for each of the severe and plausible scenarios developed. The stresses that have been modelled should be clear and explained. Where companies choose to use the PR19 prescribed scenarios and stresses, they should explain why they are specifically relevant for the assessment of their business.

This is an area where reporting across companies is inconsistent. While some companies set out their stress testing clearly, including for each developed risk scenario what has been sensitised, why and by how much, other companies provided only general comments that forecasts had been sensitised for the impact of risks.

The best disclosures were those that also explained why the level of stretch modelled is appropriate for its business, and what is being measured e.g., the impact on debt covenants, the risk to a trigger or default event, and credit ratings.

**Results and mitigation** – Companies should outline the results of their stress testing and the key impacts, and evidence its consideration of mitigating actions i.e., what measures might be realistically available in order to offset/limit the impact should the risk scenario materialise or explain why mitigation action is not necessary.

The level of detail and transparency in this area varies greatly. Rather than broad statements, companies could improve by providing a summary of the outcome of their stress testing in terms of key impacts under each risk scenario and over the assessment period. Likewise, it should be clear that the mitigation set out has been considered in light of the particular risk scenario and outcome of the stress testing, and not a generic list.

Several companies within mitigations and assumptions referred to Ofwat's duty to financeability. As we highlighted to companies' prior year, while company licences allow price limits to be reopened this is in reference to certain limited circumstances as a result of material events that are beyond prudent management control, and with a high evidential bar.

**Governance and assurance** – All companies provided a positive Board confirmation i.e. that the Board, based on their assessment, has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment. In most cases third party assurance had been confirmed as obtained.

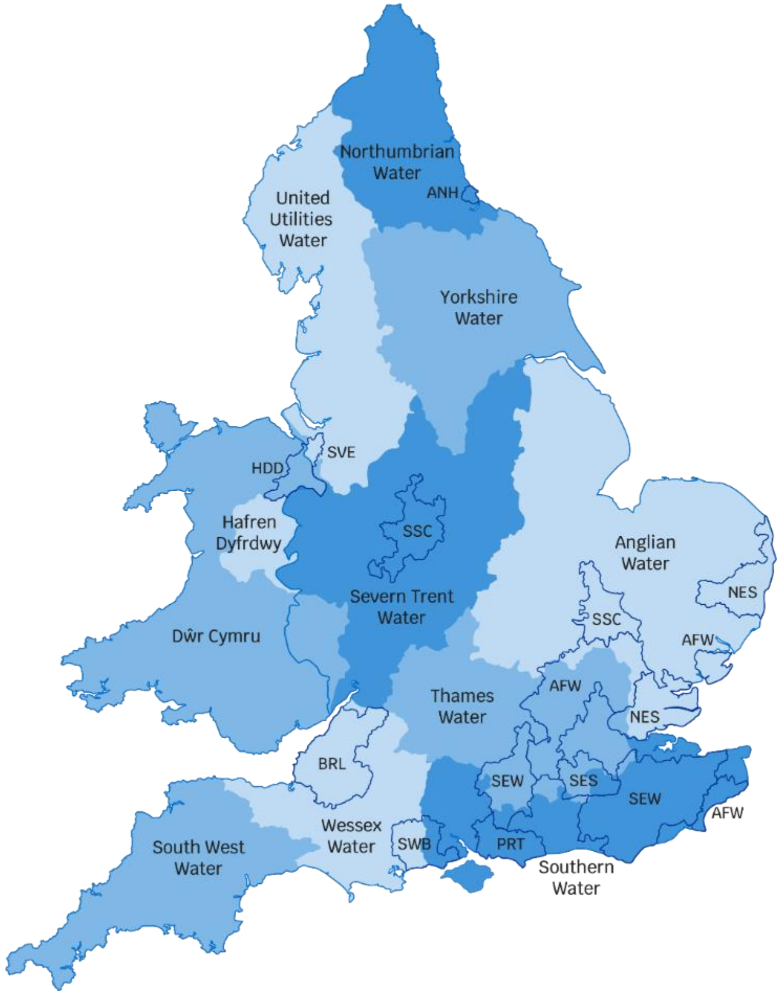
An area for improvement is companies' explanation of the internal processes and frameworks in place to ensure the outputs and conclusions in their LTVS are being robustly reviewed and challenged. This is of particular importance where the stress testing shows a potential risk to viability under the severe but plausible scenarios.

# Appendices

# Appendix 1: Glossary and abbreviations

| Abbreviation0 | Definition | Abbreviation | Definition |
|---|---|---|---|
| AICR | Adjusted Interest Cover Ratio (cash). Calculated as FFO adjusted for RCV run-off divided by cash interest paid.<br><br>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.<br><br>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. |
| AMP | Asset Management Plan, price limit periods in the water sector. AMP periods are five years in duration and begin on 1 April in the years ending in 0 or 5.The current period (2020-25) is commonly known as AMP 7 because it is the seventh price review period since privatisation of the water industry in 1989 | 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. |
| APR | Annual Performance Report, published by the appointed companies | Nominal | Interest rates, prices and costs are said to be in nominal terms if they include the impact of inflation e.g. the current value without taking inflation or other market factors into account |
| 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). |
| 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 e.g. the current value adjusted for 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 (ANH) | Anglian Water Services Limited |
| Dŵr Cymru (WSH) | Dŵr Cymru Cyfyngedig |
| Hafren Dyfrdwy (HDD) | Hafren Dyfrdwy Cyfyngedig |
| Northumbrian (NES) | Northumbrian Water Limited |
| Severn Trent (SVE) | Severn Trent Water Limited |
| South West (SWT) | South West Water Limited |
| Southern (SRN) | Southern Water Services Limited |
| Thames (TMS) | Thames Water Utilities Limited |
| United Utilities (UUW) | United Utilities Water Limited |
| Wessex (WSX) | Wessex Water Services Limited |
| Yorkshire (YKY) | Yorkshire Water Services Limited |
| Water only companies | |
| Affinity (AFW) | Affinity Water Limited |
| Bristol (BRL) | Bristol Water plc |
| Portsmouth (PRT) | Portsmouth Water Limited |
| SES Water (SES) | Sutton and East Surrey Water plc (trading as SES Water) |
| South East (SEW) | South East Water Limited |
| South Staffs (SSC) | 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: Comparability of data

▲ Contents

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 continue to keep our reporting guidance under review. We will issue further guidance and clarification where we consider it necessary and will look to incorporate this into the Regulatory Accounting Guidelines (the RAGs).

We 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 4: Explanatory notes

## 1. Published Information

All data and information contained in this report has been taken from companies Annual Performance Reports (APRs) and resubmissions, or other publicly available sources, for instance statutory accounts and reports from credit rating agencies. All water companies are required to publish information relevant to their financial performance and financial position in their APRs. The APR is a key source of data which we monitor over time.

While we have undertaken a high-level review of the information published by companies, the responsibility for the accuracy and assurance 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 2021-22 APRs prior to our publication of this report, we have updated the data in line with the known revisions made by companies. If companies were to restate figures and / or revise their 2021-22 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.

## 3. Investment grade credit rating, cash lock-up

Where an investment grade issuer credit rating is not maintained, or where one or more monitored 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.

## 4. South West Water and Bristol Water

On 3 June 2021, Pennon Group plc (Pennon) acquired the entire share capital of Bristol Water Holdings UK Limited and its subsidiaries. In March 2022, the CMA completed its investigation into the merger following its decision to accept undertakings provided by Pennon, including namely to maintain separate reporting information for South West Water and Bristol Water to enable separate price controls. The merging of the companies' licences is expected to complete early next year.

## 5. Severn Trent Water and Hafren

In 2017 Severn Trent Water acquired Dee Valley Water. Dee Valley Water became a sewerage undertaker (it had previously only been a water undertaker), took over Severn Trent Water's water and waste water business in Wales from 1 July 2018 and was renamed as Hafren Dyfrdwy Cyfyngedig (Hafren). Severn Trent continues to provide water and waste water services to customers in England (including previous Dee Valley Water customers living in England).
Severn Trent Water and Hafren remain separately regulated water and waste businesses, each with its own licence, and produce separate Annual Performance Reports.

On 31 March 2022 Severn Trent Water disposed of its investment in Hafren by way of a dividend in specie (of its holding of the entire share capital of Hafren) to its immediate parent company Severn Trent Draycote Limited*. Severn Trent Plc, listed on the London Stock Exchange, remains the ultimate parent company of both Severn Trent Water and Hafren.

## 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 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.

## 7. 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

* Dividends reported by Severn Trent Water for 2021-22 are explained as not including the dividend in specie in respect of the disposal of its investment in Hafren.

**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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