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By email: [redacted]

Lisa Gahan
Regulatory Director
South West Water Ltd

21 December 2022

Dear Lisa

Monitoring Financial Resilience – Feedback

We are writing to you to provide feedback following our review of the financial data and information that was submitted in your Annual Performance Report (APR) for the year ended 31 March 2022. This letter includes general observations applicable to the wider sector and, in the appendix, feedback on matters specific to your APR submission.

We expect you to consider and address all the points set out in this letter as you prepare and plan for the 2022-23 APR and future submissions. In respect to dividends, where we have raised a specific point(s) of feedback, we require you to provide a response in writing to set out how you plan to address our concerns and the steps you are or will be taking to ensure you fully meet our expectations in future. We expect to receive this response no later than 31 January 2023.

The feedback in this letter is in addition to any feedback and requests for action you might have received in relation to APR data and information submitted relevant to the Water Company Performance Report (2021-22) and regarding performance related executive pay.

APR Feedback

All water companies are required to publish information relevant to their financial performance and financial position in their APR. This APR data is a key source of information which we review and monitor over time and use to help form our view on the long term financial resilience of each regulated company. Some of the financial data submitted in companies' APRs for the year ended 31 March 2022 was recently published in our Monitoring Financial Resilience Report alongside our key messages and observations on financial resilience across the sector.

Each company is responsible for the integrity and assurance of the data and information that is reported in its APR. We expect all companies to review their reported metrics and outputs for accuracy and completeness in accordance with the latest Regulatory Accounting Guidelines (the RAGs).

This year we have completed a general review of the financial reporting tables and a specific review of dividend policies and decisions, the long term viability statement (LTVS) and ring-fencing certificate (RFC) submissions, together with financial flows data (Table 1F).

We have not carried out a detailed systematic assessment or audit of the reported financial data or information submitted.

Where material errors or omissions were identified we used a query process to clarify and, where necessary, companies corrected their reported information. Where changes and revisions have been made, we expect companies to republish their revised APR on their website accordingly.

Dividend policies and decisions

As monopoly providers of essential public services, water companies must be able to demonstrate to stakeholders that their approach to dividends engenders trust and accountability. In explaining dividend decisions and payments, all companies are expected to address all relevant factors, including clearly setting out how they have taken into account overall service delivery for customers and the environment, alongside their other commitments and the need for investment to support growth, long-term financial resilience and where necessary a turnaround of any poor performance.

Whilst our PR19 final determinations proposed a base dividend yield of up to 4% as a reasonable level, this was in the context of a company with little real RCV growth to support and that is performing in line with our determination in 2020-25. Consequently, we expect companies to be fully explaining dividends paid in their entirety, whether that is at the base yield or not and especially where it is above.

In 2021 we wrote to all companies about their dividend policies and provided feedback where reported dividend policies and the application of those policies did not meet the expectations that we had set out.

For 2022 we reviewed dividends on the same basis. Overall, while we consider there to have been some progress, we identified several companies that had again failed to meet our expectations to clearly set out and explain the link between their dividend decisions and payments with performance delivery for customers. Considering the substantial concerns we, and other stakeholders, have expressed on this issue for some time, this is very disappointing. For those companies that did not meet our expectations we have provided feedback in the appendix.

As noted above, if feedback has been provided regarding dividends, we expect you to deliver a written response outlining the steps you are or will be taking to address our concerns.

We highlight that as regulatory requirements and stakeholder expectations evolve over time, we expect all companies to be reviewing and updating their policies on an ongoing basis.

Long term viability statements

All companies are required to provide a statement on their long term viability (the LTVS) either in their APRs or Annual Reports. It is important that the LTVS submitted is clear and specific to each company so that a reader can understand the basis on which the Board of Directors (the Board) has reached its conclusion i.e., on whether they believe the company will be able to continue in operation and meet its liabilities as they fall due over the period of the assessment period.

Our information notice IN 19/07 – Expectations for companies in issuing long term viability statements provides guidance for companies in preparing their LTVS and sets out our expectations, including that companies should test their forward looking financial and operational plans against severe but plausible scenarios reflecting the principal risks they have identified. Further to feedback provided in December 2021, we reminded companies in May 2022 of these expectations and the need for transparency.

Our review of the statements submitted for 2021-22 found the level of detail in certain areas remains inconsistent across companies, particularly in relation to the stress testing that has been carried out. For 2022-23 we expect all companies to clearly set out the sensitivities that they have applied to their base case to test the potential impact of the principal risks identified, the outcome of that testing across the assessment period and the mitigation that is reasonably available to remove or limit that impact.

Where we consider improvement in transparency is needed specifically, we have set this out in the appendix and expect you to address this in next year's LTVS.

Ring-fencing certificates

The ring-fencing certificate (the RFC) is a certificate stating that in the opinion of the Board, the company has sufficient resources to enable it to carry out its Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted to Ofwat. The RFC is a licence requirement (Condition P31 for most companies).

For 2021-22 all companies provided a RFC, however several companies did not fully meet our expectations as set out in our guidance IN 20/01 Requirements and expectations for ring-fencing certificates. Where we identified errors or omissions in carrying out our review, these were raised with the company for correction.

In the appendix, where applicable, we have set out the key issues that we raised with you together with general points of feedback regarding your RFC. We expect all feedback to be addressed in next year's RFC submission.

Restatement of prior year accounts

This year we noted that several companies had restated their financial statements in respect of prior years for presentational reasons and/or due to errors identified.

In this situation we expect companies to provide us with details of any figures which have been restated and the reasons for those restatements. We also expect companies to provide us with an update of any APR tables where changes are necessary as a result of the restatements of their statutory accounts. This is important to ensure comparability of the information that is available to stakeholders.

Should you have any queries or wish to discuss any of the matters raised in this feedback (general or specific) please do not hesitate to contact either me or [redacted] in the first instance.

Yours sincerely

[redacted]

John Russell
Senior Director, Strategy, Finance and Infrastructure

Appendix – Company specific feedback

Dividends

The company did not meet current expectations for the following key reasons:

- We note that the dividend narrative provided in the 2021-22 APR has addressed some of the points we raised in our dividend feedback letter of 30 November 2021. We note from the narrative that the company paid outperformance dividends of £43m in relation to 2020-21, which reflected totex and financing outperformance. However, the dividend narrative didn't explain in sufficient detail how the company performed more widely against FD expectations and other considerations or demonstrate that it was appropriate and prudent to pay out these elements of outperformance, particularly when underperformance was reported across a number of commitments. We note that the financing outperformance was partly driven by inflation that was higher than the FD assumption. In our draft and final 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.

- We recognise from the narrative that some of the dividends paid in the year relates to performance in earlier years and also an outperformance dividend related to 2020-21 was paid after 31 March 2022. But we consider that the company still has more to do to transparently set out and explain to stakeholders, the application of the dividend policy each year and how it relates to performance, including where that covers more than one year.

- We also note from the dividend narrative that the base dividend of £45.0m was derived from the FD for the appointee, including the enhanced equity for fast-track status, adjusted for expected inflation of 3.6% compared to an FD assumption of 2% and FD dividend growth assumptions of 1.18%. Our expectation of a reasonable base dividend yield was 4% nominal based on the actual structure. We are unclear why your narrative refers to the base dividend being derived on the basis of the FD for the appointee and includes an adjustment for inflation.

- As noted in our cover letter, we expect a response from you by the 31 January 2023 on both the issues we have raised above and to set out how the company will address to ensure it fully meets our expectations in future.

- In addition to the above, you should expect the matter of dividends and our feedback to be raised at your meeting with Ofwat, which is being arranged as a consequence of you being identified as a 'lagging behind' company in the Water Company Performance Report.

Long Term Viability Statement (LTVS)

We found the LTVS to be clear and transparent in the following areas:

- The LTVS signposted to the company's risk register, including its process for monitoring and reviewing risk. The principal risks identified by the company were generally well explained.
- A good range of risk scenarios, including in combination, had been developed, and linked to the principal risks identified.

We found improvements need to be made next year to improve transparency in the following areas:

- The rationale for the period of assessment and the financial base case that had been assessed should be more clearly set out. The statement made was generic and should be more specific regarding the factors relevant to the company in determining that period
- In respect of the stress testing carried out, commentary referenced taking into account the budget for financial year 2022-2023 and the strategic plan to March 2027 despite the assessment period being extending to 2030.
- The LTVS confirmed that several sensitivities had been ascribed a value and applied to the baseline financial forecast to stress test the business for risks identified. However, while the LTVS referenced the Ofwat viability scenarios, the company specific sensitivities applied were not set out. We expect the sensitivities applied to be set out and clear, otherwise the reader cannot fully understand and assess what stress testing has been carried out and whether it is sufficiently stretching to reflect the risk.
- The explanation of the impact of stress testing was too general. For next year we expect the company to be clearer on the outcome and impact of each of scenario tested in terms of impact on key financial covenants considered and credit ratings, and over the assessment period.
- We would have expected to see some referencing to the acquisition of Bristol Water in the LTVS and potentially as a possible scenario tested.

Ring-fencing Certificate (RFC)

We identified several issues with this year's RFC which we expect to be addressed in next year's RFC:

- The RFC did not mention the date on which it was approved. This needs to be included in future.
- The RFC did not meet our expectations in setting out the factors that had been considered by the Board in reaching their conclusion on the matter of sufficiency of resources. In accordance with our RFC guidance note, as a minimum we expect the RFC to cover and explain how the Board has considered each of the following key areas;
    - financial resources and facilities management resources.
    - systems of planning and internal control.

- rights and resources other than financial resources.
- contracting; and
- material issues or circumstances.

- The RFC did not state where the auditor assurance statement from EY could be found. It should have referred readers to the overall auditor] assurance statement included in the APR on pages 134-136.

- Following insertion of the new condition P into the company's licence in 2020, an auditor assurance statement specifically on the ring-fencing certificate (RFC) is required under condition P37. This was not submitted this year or prior year. The issue was rectified following a query and significant chasing. In future submissions the auditor assurance should be submitted alongside the RFC.

Financial Information

- The company currently has a dispensation from this licence requirement to maintain an Issuer Credit Rating, however its licence requires the company to annually certify that it would be able to maintain an investment grade credit rating (which was certified as at 31 March 2022). In summarising the Assessment of Licence Condition P 26 (Appendix A) in the APR the wrong dividend paid value had been referenced in error.

- A breakdown of net interest paid reported in Table 1C was not provided in the APR as required. This information is needed to support calculation of interest cover ratios.

- In calculating the Adjusted Interest Cover Ratio (AICR) metric as reported in Table 4H, companies are required to apply the Ofwat provided RCV run-off value. The did not apply the RCV run-off value as set out, which had a small impact on the AICR metric.

- Table 1E was resubmitted after inconsistencies were identified between Table1E and 4B in regard to Indicative weighted average interest rates and weighted average years to maturity.

- ## Financial Flows

- No material matters identified to feedback.