

Centre City Tower, 7 Hill Street, Birmingham B5 4UA
11 Westferry Circus, Canary Wharf, London E14 4HD

By email

Andrew Beaver
Regulation & Assurance Director
Northumbrian Water

21 December 2022

Dear Andrew,

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] [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. Our key concerns are as follows:

The narrative in your APR states that Northumbrian Water took account of the full range of performance commitments, both the positive performance and the action plans to improve areas, in making its decision to pay dividends. But the narrative does not adequately explain how performance for customers has impacted decisions on dividends. There is insufficient information and explanation to enable stakeholders to understand how performance for customers has been taken into account, whether an adjustment was made, how any adjustment had been calculated or what performance was considered. The APR narrative does not explain why a 13.2% dividend yield, which significantly exceeds the 4% level set out as reasonable for a company performing in line with our determination, aligns with the underlying performance in 2021-22, particularly when underperformance was reported across a number of commitments.

We note that some of the dividends paid in the year relate to earlier years, but this has not been adequately explained in the narrative. We expect the company to consider how it can transparently set out and explain to stakeholders on an annual basis, the application of the dividend policy and how it relates to performance over the year, even where dividends are paid over two or more reporting years.

Overall, our assessment concludes that Northumbrian Water has not transparently explained why the significant dividend paid in the year was reasonable, taking account of our expectation of a reasonable base level of dividend and the performance of the company in 2021-22 and previous years.

The points of feedback relate to the dividend narrative in your 2021-22 APR. We acknowledge your recent correspondence with Ofwat regarding steps the company is taking to strengthen its dividend policy and improve transparency as well as explaining the composition of the 2021 dividends. We are due to meet in January to discuss your action plan on performance and suggest that we pick this up in that discussion.

Long Term Viability Statement (LTVS)

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

The rationale for the period of assessment was clearly set out, with references made the Board's planning cycle, the company's investment needs and PR24.

The range of risks and the principal risks are clearly set out. We note however, that the signposting between the LTVS and the principal risks could be improved (specifically, the pages referenced) to be consistent with the way it is displayed in the 'Annual Report and Financial Statements Report'.

We found transparency next year needs to improve in the following areas:

The LTVS states that the scenarios modelled to stress test the financial base case were developed after consideration of the principal risks. Greater clarity to map scenarios to the principal risks identified should be provided so that it is clear to the reader that all risks identified that could pose a risk to viability are captured.

The company's explanation of the results of the stress tests carried out should be clearer. We expect greater clarity on the impact of each scenario modelled over the assessment period. It should be clear to the reader how that scenario, and the sensitivities applied to model it, could impact the company in terms of its key financial covenants and credit rating metrics, and therefore the potential risk to viability and need for mitigation.

Ring-fencing Certificate (RFC)

The RFC this year met our requirements and expectations in some but not all respects. Points of feedback and matters to address in next year's RFC are:

The RFC did not set out the date on which it was approved by the Board. This information should be included in the body of the RFC.

The RFC did not set out a brief explanation that the RFC is a licence requirement and what the requirement involves as included in our guidance.

The RFC did not set out the required information regarding assurance statements. The body of the RFC should direct the reader to the overall auditor's assurance statement included in the APR (on pages 178-182) and should confirm that an assurance statement specific to the RFC had been separately submitted to Ofwat.

The processes and procedures that were followed by the Board, in order to satisfy themselves that the evidence detailed in the RFC is sufficient to enable them to draw a conclusion, were not clearly set out.

The RFC stated that no other material issues or circumstances had been considered. We expect the RFC to be clear and to confirm that all material matters aware had been considered, and that no other relevant factors had been identified which could impact the company's ability to carry-out its regulatory activities for the next year.

Financial Information

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.

The wrong sign was used for derivative values set in 4I. As set out in the RAGs out-of-the-money (liability) positions should be presented as positive and in-the-money (asset) positions should be presented as negative. As required by the RAGs a footnote to the table should also be provided to explain that this is the case.

Debt instruments have scheduled repayment end dates. The weighted average years to maturity across debt instruments as reported in Table 1E was different to that reported in Table 4B (Analysis of debt). This was explained as an error and subsequently revised.

Financial Flows

No material matters identified to feedback.