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By email

Jamie Jones
Regulation Manager
Portsmouth Water

21 December 2022

Dear Jamie,

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

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Appendix - Company specific feedback

Portsmouth Water Limited

Dividends

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

We note from the APR narrative that the company paid dividends of £3.397m in relation to 2021-22, of which £0.53m was an outperformance dividend reflecting its ODI reward. But 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.

We recognise from the narrative that some of the dividends paid in the year relate to performance in earlier years (£1.676m relating to 2019-20 and £3.439m relating to 2020-21). We consider that the company 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.

The APR narrative suggests that the dividend paid in the year was increased to include an additional recirculating dividend which was paid to fund interest due to Portsmouth Water on a loan made to its parent company. Our expectation of a reasonable base dividend yield of 4% should reflect total dividends paid, as the intended use of dividend funds once paid does not affect our view of a reasonable base dividend yield. The total dividend paid should be explained in relation to company operational performance, obligations and commitments to customers and the other factors we set out in our PR19 expectations.

Your dividend narratives states that the company believes that a base dividend yield of 4% is appropriate. Our final determinations stated 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. As Portsmouth Water had real projected RCV growth of 12.1% in our PR19 final determination, the expectations set out at PR19 would imply a base dividend yield well below 4%.

Overall, our assessment concludes that Portsmouth Water has not transparently explained why the dividend paid in the year was reasonable, taking account of the performance of the company or its longer term financial needs.

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.

Long Term Viability Statement (LTVS)

The LTVS this year met expectations in most respects. An area where transparency needs to improve next year is:

There was an inconsistency with the period of assessment date with references to both 2031 and 2032 within the LTVS.

The governance and review processes in place to ensure the outputs, on which the conclusion in the LTVS is based, are reviewed and challenged should be clearer. Although relevant information was available, it was not adequately signposted for the reader in the body of the LTVS and therefore more difficult to locate.

Ring-fencing Certificate (RFC)

The RFC this year met our requirements and expectations in most respects. The main factors which the Board has taken into account in giving its opinion for the RFC were set out well.

Financial Information

A difference was identified between the Total Borrowings value reported in Table 1C and the Total Borrowings value reported in Table 1E, which was not fully explained in the narrative provided.

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.

Per the RAGs guidelines an analysis is required of the appointed current tax charge or credit reported in line 1A.12 comparing this to that charge or credit resulting from applying the standard corporation tax rate to the profit or loss on ordinary activities for the appointed business before tax and any fair value movements as shown in Table 1A. The tax analysis provided on page 53 of the APR was not clear due to the analysis starting with the profit or loss on ordinary activities (before tax and any fair value movements) of the company on a statutory basis i.e., not the appointed business only, and comparing that to the overall net tax charge (1A.12 plus 1A.13) not the tax credit reported in line 1A.12.

Financial Flows

A query relating to the reported value for Variance on Corporation was raised, which identified that the calculation was not in accordance with the definition in RAG4, the value was subsequently adjusted to reflect the requirements in RAG4. Companies should ensure that they follow the Regulated Accounting Guidelines when completing their APR.