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By email

Matt Greenfield
Director of Economic Regulation
Wessex Water

21 December 2022

Dear Matt,

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 for the following key reasons:

We note that the dividend narrative provided in the 2021-22 APR is very limited and does not address any of the feedback we raised on the 2020-21 APR dividend narrative in our letter of 30 November 2021. This is particularly concerning given our previous feedback on this subject and our recent consultations on financial resilience.

Your APR states that the board took account of good performance against most performance commitments when deciding on dividend payments. But the narrative explaining the decision on dividends paid in the APR does not explain and link to evidence of good performance. The APR narrative does not justify why a 5.3% dividend yield, which exceeds the 4% level set out as reasonable for a company performing in line with our determination with little real RCV growth, aligns with the underlying performance in 2021-22. The company needs to transparently explain why a yield of 5.3% is reasonable and is in the interests of customers, in particular noting the level of real RCV growth (10.6%) over 2020-25 included in our determination.

Overall, our assessment concludes that Wessex 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 financing 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)

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

The company's overall risk identification and risk management processes were well signposted and clear. The principal risks identified by the company were generally well explained.

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

The basis and rationale for the period of assessment chosen should be more clearly set out. Whilst reference was made to the company's delivery plan up to 2025 and projections submitted as part of the business planning process from 2025 to 2030, there was little explanation or links to the referenced planning process or projections, including in regard to

how plans are reviewed and updated. Setting out the short term factors considered however was helpful.

In several places the LTVS refers to risks, shocks, and scenarios. It was difficult to differentiate between these, to link together the shock and scenario, and map to the principal risks that had been considered. The statement could have been simplified and should be clearer in explaining the scenarios that have been modelled i.e., what is being stress tested and why based on the risks identified.

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.

Explanation provided of the mitigating actions available was broad and not aligned specifically to the scenarios and the outcomes of the stress testing carried out. The mitigating actions available and their effectiveness is likely to differ depending on the scenario and the impact.

Commentary on the governance and review processes in place was also at a high level. As a minimum links should be included to direct the reader to relevant areas (of the annual report or other reports) where for instance the role of the audit and risk committee and the Board, and the process for challenge and oversight, is more clearly explained.

Ring-fencing Certificate (RFC)

The RFC this year met our requirements and expectations in most respects. A minor point of feedback to address in next year's RFC is:

The RFC did not state where the auditor assurance statement from EY could be found. The RFC should refer readers to the overall auditor assurance statement included in the APR on pages 118-123 and should set out that an auditor assurance statement specific to the RFC has been separately submitted to Ofwat.

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 outlook for the credit rating provided by rating agency Moody's, which is monitored by Ofwat for licence purposes, was not reported in Table 4H as is required.

Financial Flows

No significant issues were identified for discussion from our review.

One minor point, in the calculation of totex out / (under) performance, the company had included 'third party revenue non price control' this is incorrect and should not be included. The company amended the calculation to exclude this element. (The value involved did not have a material impact on the table).