Ofwat

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By email

Chris Offer
Head of Regulation
Yorkshire Water

21 December 2022

Dear Chris,

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

Our assessment concluded that the company's dividend policy, application of the policy and the dividend narrative published in the APR was generally in line with our current expectations. As a reminder, any future dividend payments and disclosures must be made in line with requirements and expectations in place at the time, including any that may arise from our proposal to strengthen the dividend policy licence condition and any changes to dividend reporting requirements in the RAGs.

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, including in regard to setting out the roles and responsibilities of the Board and relevant committees, the risk horizons considered, and the processes around identifying and monitoring principal risks.

A broad suite of scenarios had been developed to stress test the financial base case with explanations on how they link to the principal risks identified.

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

The company's rationale for the chosen period of assessment and the financial base case that had been assessed should be more clearly explained. The statement was generic and not specific of the factors that had been taken into consideration in determining the period.

The company's explanation of the development of its broad range of scenarios to create its severe and plausible scenarios/sensitivities, including in terms of cost impact, probabilities and totex impact was complex, and therefore difficult to assess. Further discussion with the company has helped to explain the testing carried out and its robustness, however for transparency and to help the reader in their understanding of what has been stress tested and why, the statement could be simplified and set out in a clearer format.

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. The company’s processes for monitoring risk to a trigger event under in its financial covenants could also be set out in support.

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.

The company's 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 or signposted in the LTVS.

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 was dated 5 July 2022, but the Deloitte audit report refers to a statement of 15 July 2022. For consistency, the Deloitte report should have referred to 5 July 2022, the date on which the RFC was approved.

In certain areas we expect to see greater detail than was provided. For example, we would expect to see statements on liquidity in the body of the RFC similar to those made under your going concern declaration. Moreover, we considered your RFC did not adequately set out the matters of potential challenge considered. As a result, in comparison to other RFCs submitted that we reviewed, your RFC was not fully reflective of the potential challenges faced by the company e.g., around performance matters, the potential for penalties and ongoing investigations etc. We note, for instance, the company is being investigated for how they manage their sewage treatment works but this was not mentioned in the material issues section of the RFC.

Financial Information

The non-household (business) retail market opened to competition in April 2017, following which all companies except for Hafren and Dŵr Cymru exited the non-household retail market. The company however continues to incorrectly report a business retail margin. Whilst not material, the company does not operate or have a separate business retail price control, and therefore all relevant revenue and cost should be captured in the household retail margin.

In Table 1A.15 dividends were reported in the wrong signage. This was subsequently revised.

Regarding Tables 1A, 1B, 1C and 1D (which reflect the primary financial statements), there is a column to report any resulting differences between statutory and regulatory definitions on a line by line basis. Where any individual values recorded in these lines are considered material then a narrative explanation should be provided on what these differences relate to.

In respect to Table 1A, 1C and 1D the company made adjustments directly to the statutory numbers presented in the APR that were not set out and explained. In future we expect all adjustments made to be clearly explained.

In relation to the above, a direct adjustment had been made in order to represent the defined benefit pension cost (which is accounted for by the company on a defined contribution basis). This resulted in the statutory loss reported in the APR differing to that reported in the statutory accounts. On query this was later explained and reversed, resulting in the relevant tables and affected metrics being restated.

Financial Flows

No significant issues were identified in relation to the data submitted. However, the company did submit an alternative Table 1F, stating:

" We are continuing to discuss with Ofwat the development of table 1F and whilst we still have areas that we would like to be considered further we have followed our 2020/2021 APR process and have included a second version of the table to attempt to show the impact of areas where we remain in discussion with Ofwat"

We believe the discussions have been completed and do not consider it appropriate to reference ongoing discussions with Ofwat alongside the submission of an alternative version of the table.