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By email

[redacted]
Director of Regulation, Strategy and Asset Management
South West Water and Bristol Water

21 December 2023

Dear [redacted],

Monitoring Financial Resilience – Feedback

We are writing to provide you with some feedback following our review of the financial data and information that was submitted in the company's Annual Performance Report (APR) for the year ended 31 March 2023 (2022-23). This letter includes general observations applicable to the wider sector and, in the appendix, feedback on matters specific to the company's APR submission.

We expect you to consider and where relevant address all the points set out in this letter as you prepare and plan for the 2023-24 APR and future submissions.

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 and regarding performance-related executive pay.

APR feedback

Some of the financial data and information submitted in companies' APRs for the year ended 31 March 2023 was recently published in our Monitoring Financial Resilience Report alongside our key messages on financial resilience across the sector.

In line with last year, we carried out a general review of the regulatory financial reporting and metric tables[1] and a review of companies' dividend disclosure, long term viability statement and ring-fencing certificate submissions.

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

[1] Tables 1A, 1B, 1C, 1D, 1E, 1F, 4H, 4I, 4V and 4W.

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. We remind companies that they have legal obligations in their licence in relation to this reporting which are enforceable by Ofwat. We will continue to monitor how companies are meeting these obligations and take action where needed.

Where relevant we have provided feedback on companies reporting in the appendix which we expect companies to consider and address going forward.

Dividend disclosure

Companies and their Board of directors ('the Board') are responsible for setting dividend policy and reaching dividend decisions, taking account of relevant obligations including statutory and licence requirements.

We have been clear that the base dividend that we set out at a price determination reflects our view of an appropriate level of dividend for a company performing in line with its determination across all relevant indicators[2]. It does not mean that investors are entitled to that level of dividend if it is not supported by company performance. There are a number of reasons why a dividend yield below this level may be appropriate for an individual company, such as to address operational or performance issues, pension funding concerns or improve financial resilience or where companies must fund significant investment programmes.

We expect all companies to clearly explain and set out their choice of dividend yield. Stakeholders should be able to understand the basis on which the Board has reached their conclusion and be confident that the decisions reached on dividend level and distribution have taken the company's performance overall into account.

Compared to the prior year there has been an improvement in reporting transparency and companies' articulation of their dividend decisions. Several companies set out and quantified the components and calculations of the dividend amount, including the impact of performance, alongside the wider factors taken into consideration in determining a dividend distribution. There are companies that need or can do more to better explain and set out their dividend decisions and in the context of performance delivered.

In March 2023 we published our decision to implement a range of modifications to companies' licences. This included amending the dividend policy condition to require companies to declare or pay dividends only in accordance with a dividend policy that takes account of factors including delivery for customers and the environment and financial

[2] At PR19 we considered that a base dividend yield of up to 4% was a reasonable level for companies that have little real RCV growth and that perform in line with our determination in 2020-25.

resilience over the longer term. This licence modification came into effect on 17 May 2023, being post the 2022-23 APR year end. In June 2023, to help companies understand our expectations, we also published guidance on the factors we consider in assessing dividends declared or paid. We encourage all regulated companies to be considering their dividend policy, application, and reporting transparency in light of our decision.

Long term viability statements

All companies are required to provide a statement on their long term viability (LTVS) either in their APR 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 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 assessment.

We assess the quality and transparency of each company's LTVS across several areas, based on our expectations as set out in IN 19/07, Regulatory Accounting Guidelines, reporting requirements and recognised good practice. Alongside our consideration of dividend disclosures, we reflect on our findings in our wider assessment of companies' financial resilience, which may lead to increased monitoring and engagement, and require action from the company.

Overall, we found companies had reflected on feedback provided in the prior year, with an improvement both in the level of detail and transparency in the 2022-23 statements submitted. In particular we have noted improvement in companies' explanation of:

- Structures and processes for identifying and assessing principal risks.
- The basis for determining forward-look periods.
- The basis on which viability has been tested, including testing of the financial base case, and the impact on credit metrics and triggers under financial covenants.
- How scenarios used for stress testing base case link to principal risks identified.
- Governance processes followed in reaching conclusions.

Few companies, however, met our expectations in all respects and there remains variation in the clarity and level of information in companies' statements in some key areas, namely regarding the level of sensitivity applied to stress test forecasts and the outcomes of testing, alongside the mitigations available to address potential downside. Material points of feedback are included in the appendix.

Ring-fencing certificates

For 2022-23 all companies provided a ring-fencing certificate (the RFC[3]). 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.]

In the appendix, where applicable, we have set out areas for improvement, together with general points of feedback.

APR quality, review, and checks

This year we noted that several companies had made data errors including calculation errors, using incorrect signage, values not agreeing across APR tables, and non-submission of requested breakdowns.

Each company is responsible for the integrity and assurance of the data and information that is reported in its APR and submitted. We expect all companies to review all the information provided as part of their APR submission for accuracy and completeness in accordance with the latest Regulatory Accounting Guidelines (RAGs), and to explain their data in APR commentary where required and/or useful to facilitate the reader's understanding of the data submitted.

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

Yours sincerely

[redacted]

Helen Campbell

Senior Director, Sector Performance

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[3] 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 (paragraphs 31-36 of Condition P for most companies).

Appendix – Company Feedback

South West Water Limited (including the Bristol Water area)

Dividends Disclosure

We have reviewed the company's dividend disclosure, and regarding dividend reporting and transparency, we comment as follows:

- Dividend commentary set out the key components and factors that the Board takes into consideration when assessing and concluding on dividend level and distribution, and a breakdown of the dividend amount by key dividend policy area was provided.

- As reported, total dividend included a base return. Although a summary of the base dividend calculation was set out, providing further explanation or referencing in the company's reporting would improve transparency. For instance, in respect to the yield and the RCV values applied, the basis for calculating equity in reference to the notional company structure, the enhanced equity amount, and the inflation assumptions used (noting the company's dividend policy for base dividend annual growth of CPIH + 1.18%, with a further adjustment for inflation). We expect a company's choice of dividend yield to be clearly explained and set out in all respects.

- The dividend as set out included an amount to reflect performance namely totex, ODIs and financing. APR commentary explained that in determining outperformance a calculation of RoRE is used which differs from that set out in table 1F (Financial Flows). For transparency, the calculation used should be set out or referenced, alongside how this aligns with table 1F.

- As reported, a large proportion of the performance dividend was attributable to financing outperformance however the drivers of that outperformance were not sufficiently clear in the commentary, including the impact of inflation. We expect all outperformance to be clearly explained, together with the factors taken into account by the Board when deciding to distribute that outperformance.

- We note the Board's decision to reduce the dividend amount payable in 2022-23 to lower than the statutory profit after tax in the year excluding non-underlying items, in line with the company's dividend policy. However, the non-underlying items reported were not fully explained or referenced in the disclosure, and it was not clear whether the amount determined as restricted is expected to be carried forward for potential distribution in future years.

- In the dividend summary, dividend yield was not calculated in reference to actual yearend regulatory equity. To improve transparency and avoid confusion, the disclosure could set out or explain how the yield reported agrees to the dividend yield reported in table 4H.
- As reported, the total dividend paid in the year by the company included a dividend from non-appointed activities. Whilst the dividend disclosure was in reference to the total dividend from the Appointee, in line with our dividend policy licence condition and dividend policy guidance, it was not clear how the non-appointed business contribution amount had been determined.

We expect the feedback points and comments raised above to be considered and addressed in the company's dividends disclosure next year.

Bristol Water

A total dividend was paid by Bristol Water in the period from 1 April 2022 to 31 January 2023, prior to, and as part of, the statutory transfer of its regulated business to South West Water[4]. Of the total £64.3 million dividend, £61.1 million was paid to simplify the financing structure of the Bristol Water corporate group as part of its acquisition by Pennon Group (and ultimately used to repay an outstanding loan due to the company).

In future reporting we expect dividend disclosure to reflect the performance of the company as a whole.

Long Term Viability Statement (LTVS)

Following feedback provided to the company last year, transparency has improved in respect to the company's reporting and signposting of risk identification and risk management processes.

The LTVS was not sufficiently clear in the areas below, and we expect to see an improvement in reporting transparency next year.

- The sensitivities that were applied to the baseline financial forecasts to stress test the principal risks identified were not clear in the commentary. Whilst the LTVS provided some narrative and explained that sensitivities were ascribed a value with reference to risk and combined to assess the impact on the viability of the company, the nature and extent of

[4] **Following its acquisition by Pennon Group Plc in June 2021, on 1 February 2023 the activities of Bristol transferred to South West, resulting in a termination of Bristol Water Plc's licence. Separate reporting information continues to be provided for South West and Bristol and Ofwat maintains separate price controls.

the sensitivities applied was not clear, for example the inflation assumptions and the totex sensitivities applied.

- Whilst we note the company's comment that there is interaction between risks, and its conclusion that none of the individual principal risks would in isolation, or in aggregate, compromise the company's viability over the assessment period, further information on the potential outcomes of the stress testing should be provided. For instance, the basis on which viability is considered and measured, the thresholds at which viability could be challenged, the ability to maintain an investment grade credit rating, the extent of the potential impact and the scale of mitigation that could be required. Information on stress testing outcomes and mitigation is important as it enables the reader to understand the basis on which the Board reached its conclusion on risks to viability.

Ring-fencing Certificate (RFC)

Conditions P32 to P37 for South West's licence set out requirements related to the Ring-fencing Certificate (RFC) and statement. RFC guidance note IN 20/01 (published in February 2020) provides supporting guidance to help companies comply with the RFC conditions. The company's RFC submission for 2022-23 did not follow our RFC guidance in all areas. The following issues were identified which we expect to be addressed in future submissions:

- The RFC did not include the date on which the RFC was approved which should be set out.

- The RFC did not state that it had been subject to auditor assurance, nor did it state where the auditor assurance could be found. It should have referred readers to the generic assurance included in the APR (on pages 77-79) and it should have mentioned that, as required by condition P37, an assurance document specific to the RFC had been separately submitted to Ofwat.

- The licence requires a statement of the main factors which the Board has taken into account in giving its opinion for the RFC. To ensure a broad enough range of factors have been considered, we expect each RFC to cover at least the six key areas listed in our guidance and to include a specific and detailed list of the main factors considered under each key area. As a minimum, we expect all companies to consider the factors in the Appendix to our guidance, or state why these are not appropriate. In its RFC, the company had not clearly set out the factors considered by the Board by key area and had listed only five factors. This is not in line with our guidance, such that the statement was not sufficiently clear or comprehensive.

Financial Information

In regard to the APR financial data and information reported by the company, we raised queries on the following matters:

- In calculating the Adjusted Interest Cover Ratio (AICR) metric in table 4H (4H.16) the company did not apply the RCV run-off value as provided by Ofwat and required under RAG 4.11.
- Full breakdowns of the Interest Cover Ratio (4H.15) and Adjusted Interest Cover Ratio (4H.16) calculations were not provided in the APR narrative as required under RAG 4.11.

The above identified errors were considered by the company and revisions agreed, with the corrected values reflected in our Monitoring Financial Resilience (MFR) Report.

We expect all companies to carry out thorough checks of their APR data and narrative, and in accordance with the latest RAGs, before submission to avoid such errors.