Ofwat

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By email

[redacted]
Head of Regulation
Yorkshire 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

[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

Yorkshire Water Services Limited

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 wider factors taken into consideration by the Board when assessing and concluding on the dividend level and distribution.
- The basis on which a dividend is assessed and determined needs to be more clearly set out. Although commentary explained that adjustments are made to a base dividend, for example to reflect in-the-round company performance and the need for reinvestment, and that for 2022-23 a reduction to the base dividend was appropriate on this basis, providing a breakdown and/or further detail in the company's reporting would improve transparency. For instance, in respect to the company’s calculation of its base dividend and the yield applied, the impact of the adjustments made to the base dividend level, and the performance areas and measures or indicators reflected in the dividend level. We expect a company’s choice of dividend yield to be clearly explained and set out in all respects.
- The APR included comments such as 'the dividend has been paid to cover costs relating to the entity that have been incurred elsewhere in the group' and 'distributions made to the parent company to make interest and loan payments'. It is not clear if this was a factor in the Board's dividend decision making for 2022-23, but to clarify we do not expect a dividend payment to be rationalised primarily by reference to an amount needed to service an obligation of a related company.
- The statement that the dividend 'represents a total dividend yield of 2.4% compared to a regulatory base yield of 4%' required further explanation.

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

Long Term Viability Statement (LTVS)

Following feedback provided to the company last year, transparency has improved and the LTVS provided for 2022-23 met our expectations in most respects.

Ring-fencing Certificate (RFC)

The company's ring-fencing certificate met the requirements set out in its licence and our guidance note IN 20/01.

Financial Information

In regard to the APR financial data and information reported by the company, we raised a query on the following matter:

- In table 1F financial flows, in calculating the Cost of debt impact on the return on regulatory equity (the impact arising due to the company's actual cost of debt being different to the allowed cost of debt in the Final Determination), the Fisher equation had not been applied as required under RAG 4.11, 1F.7, impacting on the value reported.

The above identified error was 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.